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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937

No. 600

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

MOUNTAIN PRODUCERS CORPORATION,

Respondent.

BRIEF FOR THE RESPONDENT.

HAROLD D. ROBERTS,
Attorney for Respondent,
First National Bank Building,
Denver, Colorado.

RANDOLPH E. PAUL,
VALENTINE B. HAVENS,
70 Pine Street,
New York, New York.
Of Counsel.

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No. 600

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

MOUNTAIN PRODUCERS CORPORATION,
Respondent.

BRIEF FOR THE RESPONDENT.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 31) is reported in 34 B. T. A. 409. The opinion of the Circuit Court of Appeals (R. 151) is reported in 92 F. (2d) 78.

Jurisdiction.

Grounds of jurisdiction of this Court are noted in petitioner's brief.

Statement of Case.

The summary of the facts in the subdivision of petitioner's brief entitled "Statement" is accurate and sufficient in scope to serve as a general background to the discussion of the two totally separate questions here involved. Additional detailed facts, with record references, as well as corrections of factual

statements in other parts of petitioner's brief, we have placed in the two main subdivisions of this brief to which they apply respectively.

We shall adopt the names used by petitioner; that is, we shall refer to respondent's affiliate, The Wyoming Associated Oil Corporation as Wyoming Associated, to The Midwest Oil Company as Midwest, and to The Midwest Refining Company as the Refining Company.

POINT I.

Wyoming Associated is exempt from Federal Income Tax on the share of income received by it from the State School Lease.

Summary and Scope of the Argument.

On this point the court below held that the principle of *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, rules the instant case. The petitioner, in Subdivision I B of his brief,* challenges the validity of the decision of this Court in the *Coronado* and *Gillespie*† cases, and asks that these decisions be overruled. We submit that no such attack upon the

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* By a footnote to petitioner's brief (Pet. Br. 25) it is conceded that this attack upon the *Coronado* and *Gillespie* cases is not forecast by the grounds for certiorari urged in the petition in this case. Petitioner then refers to its memorandum, filed, not in this case, but in the *Bankline* case (No. 388, this term), in which some reference to conflict between the *Coronado* and *Jergins Trust* (*Burnet* v. *A. T. Jergins Trust*, 288 U. S. 508) cases was made. As the *Bankline* case deals with California tide lands, and not with State school lands, either in Oklahoma or in Wyoming, the question there presented is quite different from that here involved. See page 11 of this brief.

† *Gillespie* v. *Oklahoma*, 257 U. S. 501.

Coronado and *Gillespie* decisions is proper, in view of the limited grounds for review stated in the petitioner's petition for certiorari. In a footnote on page 25 of his brief, petitioner admits that the petition for certiorari was limited to the propositions (1) that the court below had improperly *extended* the *Coronado* case, and (2) that there was a substantial conflict with *Bankline Oil Co.* v. *Commissioner,* 90 F. (2d) 899 (C. C. A. 9th), certiorari granted No. 388, this Term. As thus indicated, there was no mention in the petition for certiorari of a desire to have the *Coronado* and *Gillespie* cases overruled; indeed, the clear indication in the petition for certiorari is that these decisions were accepted by petitioner. The decision of this Court in *Morehead* v. *New York, ex rel. Tipaldo,* 298 U. S. 587, 604, makes it clear that the review granted in this Court can be no broader than that sought by the petitioner in an application for certiorari. The *Morehead* case and many other cases support the proposition that this Court "confines itself to the ground upon which the writ was asked or granted".* The *Morehead* case is particularly in point because there this Court drew a distinction between a reconsideration of the constitutional question previously determined in the case of *Adkins* v. *Children's Hospital,* 261 U. S. 525, which had not been requested in the petition for certiorari of the *Morehead* case, and an examination of the question of whether the *Morehead* case could be distinguished on its facts from the earlier *Adkins* decision. The *Morehead* petition for certiorari being on this latter ground alone, the Court limited its consideration to this single point, and refused to re-examine the constitutional question decided in the *Adkins* case itself.

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* *Alice State Bank* v. *Houston Pasture Co.,* 247 U. S. 240, 242; *Zellerbach Paper Co.* v. *Helvering,* 293 U. S. 172, 182; *Helvering* v. *Taylor,* 293 U. S. 507, 511; *Johnson* v. *Manhattan Railway Co.,* 289 U. S. 479, 494.

Since the question of the present effect of the *Coronado* and *Gillespie* cases, if it be within the scope of this hearing, lies at the very threshhold of this phase of the case, we shall devote the first part of our argument to a discussion of the *Coronado* and *Gillespie* cases, pointing out that they are in no sense overruled by any of the decicions cited by respondent. The *Coronado* and *Gillespie* decisions of this Court, as well as the decision of the lower court in the instant case, recognize the immunity from tax burden of a trust fund or its income to the perpetual protection of which the good faith of the federal government has been pledged by compact with a State or Indian tribe. In the instant case:—(a) The character of the land from which the income was obtained, (b) the source of the State's title thereto (a grant from the United States for school purposes made when the State was admitted to the Union), and (c) the nature of the express trust "for the exclusive benefit of the public schools * * * forever inviolate and undiminished"*, under which the land and all income accruing to the State therefrom are held, are all identical with the corresponding elements in the *Coronado* case. These cases may be clearly distinguished from cases in which the fund or income claiming protection, though connected with some branch of government, is not so specifically dedicated to an unquestioned governmental function, such as public education, that any imposition of tax burden "would be such a direct interference with the functions of government itself" plainly beyond the taxing power. (*James* v. *Dravo Contracting Co.*, 82 L. Ed. Ad. op. 125, 138, quoting from *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 524). In terms of practical results that is what a tax will mean to the State of Wyoming, whether the immunity be treated as absolute as in the case of "public securities", or as qualified

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*Sec. 6, Art. VII, Constitution of the State of Wyoming, accepting United States land grant (quoted in Appendix, pp. 57-58).

and dependent upon degree of burden as in the case of certain types of independent contractors.

In subdivision IA of his brief, the petitioner seems to concede these elements of identity, but denies the applicability of the *Coronado* case upon the theory that the income received by Wyoming Associated is the income not of a lessee, but of a corporation having no "direct contractual relation" with the State, and upon the theory that in the instant case no tax is "laid upon an instrumentality of the government" (Pet. Br., 16, 21, 22).

Opposing this the respondent claims that even though the doctrine of the *Coronado* case be applied "strictly and only in circumstances closely analogous to"* those under which the doctrine had originated, it was no extension of the doctrine to apply it in this case for the reasons, *first,* that Wyoming Associated was in substance a direct lessee of the State of Wyoming, and, *second,* that if it were not a direct lessee, the income must be viewed as accruing to Midwest as trustee, and was hence exempt when passed on by it to its beneficiary, Wyoming Associated. The alleged distinction made in the dissenting opinion in the court below based upon cases of the *Wanless* type† does not, under these circumstances, as we shall point out, meet the issue.

I.

The Authority of the Coronado Case Is Not Impaired by any Later Decision.

Neither the *Gillespie* case nor the *Coronado* case has ever been overruled by this Court. The former case was decided some fifteen years ago, and the latter over five years ago.

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* Quoted from *Burnet* v. *A. T. Jergins Trust, supra,* 516.

† *Wanless Iron Co.* v. *Commissioner,* 75 F. (2d) 779 (C. C. A. 8th), Certiorari denied, 295 U. S. 765, discussed on page 27 of this brief.

The fact that both decisions were by divided courts has not in any way restricted the reliance placed upon them by lessees dealing with types of property falling strictly within their scope. Both decisions have established rules of property, and large commitments, in the form of leases carrying royalties at extraordinarily high rates, have been made upon the faith of them.

It is naively suggested by petitioner (Pet. Br., 31) that this whole realm of tax law would be simplified if this entire field of tax exemption be abolished, thus making it unnecessary for any court to determine its proper limits. This neat disposition of the problem, consisting of a denial that it exists, is, of course, always available. But this Court has refused on many occasions to adopt that solution of a difficult problem. The argument of the Solicitor General is essentially the same as his argument in the *Dravo* case,—that the test of immunity be simply whether there is discrimination in the tax. Mr. Justice Roberts completely demolished this argument in his dissenting opinion in the *Dravo* case, and the majority opinion is most careful to state the conditions under which immunity shall continue to exist. In this respect the Solicitor General is here asking for a reargument of the *Dravo* case.

The *Dravo* opinions recognize the difficulty of determining the precise place at which this line between taxability and exemption shall be drawn when governmental instrumentalities of various types are involved. Both the majority and minority opinions do much, however, toward establishing landmarks and criteria. It is made clear by the majority opinion in the *Dravo* case, *supra,* 138—

> "* * * that the nature of the governmental agencies or the mode of their constitution could not be disregarded in passing on the question of tax exemption, as it was obvious that an agency might be of such a character or so intimately connected with the exercise of a power or the performance of a duty by the one government 'that any taxation of it by the other would be such

a direct interference with the functions of government itself as to be plainly beyond the taxing power.' "

Instances of these agencies of one government, requiring absolute protection against taxation by the other, then given in the opinion, are (1) a government officer with respect to his salary, (2) public securities, (3) an agency created and controlled by a government exclusively to enable it to perform a governmental function.

In commenting upon another group of agencies not all of which are entitled under this rule to *absolute* exemption, the majority opinion refers to *Metcalf & Eddy* v. *Mitchell, supra,* 137, as a "pivotal decision" in which it was determined that an independent contractor, when he contracts with a government, does not have his earnings or compensation absolutely protected against taxation, but that in independent contractor cases the degree of burden—the substantial nature of the interference—must be scrutinized.

It is pointed out in the minority opinion that not all *independent contractors* are in this latter class possessing only qualified immunity, because *public securities,* admittedly entitled to absolute protection, represent nothing but independent contracts to lend money on the one side and to repay with interest on the other, from which it is argued that the converse of the rule in *Metcalf & Eddy* v. *Mitchell, supra,* is not true. To apply in the instant case the rule common to the majority and minority opinions in the *Dravo* case, the mere fact that Wyoming Associated may properly be called an independent contractor is not of itself enough to prove that its income from the contract cannot have absolute tax exemption; otherwise, holders of public securities would be excluded from exemption by the mere fact of independent contract. The *Coronado* case is, therefore, not discredited by pointing out that the lessee of Oklahoma school land was an independent contractor; neither is the instant case decided by the fact that Wyoming Associated entered into a lease with the State of Wyoming as an independent con-

tractor for motives, from its point of view, of private gain (Cf. Pet. Br., 9).

The net result of the classification of cases into those having *absolute* exemption and those having *qualified* exemption dependent upon substantial burden, adopted in the *Dravo* case, is that independent contractors dealing with the government are not like public officials in an absolutely exempt class by virtue of their status as contractors, but that particular contractors may or may not be entitled to absolute exemption, depending upon whether the nature of the public function to be performed by the contract is so "intimately connected with the * * * performance" of a government duty as to make that contract an essential instrumentality of the government itself. Certainly the majority opinion in the *Dravo* case recognizes that independent contractors may have the status of absolute exemption. As the *Gillespie* case is cited with approval in *Metcalf & Eddy* v. *Mitchell, supra,* and the latter case is in turn cited with approval in the *Coronado* case, while *Metcalf & Eddy* v. *Mitchell, supra,* is treated as a "pivotal decision" in the *Dravo* case, it would seem that each of these four cases is to be taken as modifying and explaining the others, and that there is no justification for jumping to the conclusion that the first and third in chronological order have been silently overruled.

We submit that the *Coronado* case (and with it along parallel lines the *Gillespie* case) can be reconciled with the *Dravo* case, and with all the many cases in this field collected in that decision, by taking either or both of two logical and non-conflicting views of the facts: (1) The recovery to the maximum extent of the mineral value of *school grant* land is so intimately connected with the performance of a State function that a lease from the State to an independent contractor is an instrumentality of government entitled to absolute tax exemption, or (2) the degree of burden resulting from taxing the income from the lease of such a *State school land* lessee is so substantial and direct as to make such a tax

a serious interference with government. We urge the view first stated. If there was ever a situation in which the protection which the State demands for services rendered by an independent contractor calls for immunity from tax burden, that case is one like the instant case, in which the burden is sure to interfere with the carrying out of a grant for public education.

One clear distinction between the *Coronado* case and the *Gillespie* case, on the one hand, and all the cases compared with them by petitioner on the other hand, is that in the first named of these cases a trust fund or trust income exists, to the inviolate and perpetual protection of which the federal government has by solemn compact pledged itself. For the taxing arm of this government to take back, whether directly or indirectly, a part of the fund or income so assured, as is threatened here, savors of bad faith and violates a solemn compact.

In the *Coronado,* and in the instant case, the ultimate source of the income sought to be taxed was land granted by the federal government to a State, for the purpose of common schools, at the time of its admittance into the Union. Realization of the full value of these lands for schools was an activity enjoined upon the State by the federal government, *to insure education* upon a permanent basis. In accepting the grant, the State in each case was required to throw around the subject matter of the grant protective clauses of its constitution, which are phrased in almost extravagant language.* It was in response to requirements of Congress that each State "pledged her faith",† and, by emphatic constitutional provisions such as these, threw every conceivable safeguard around these school land grants and the proceeds

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* Note such phrases as "exclusive benefit", "forever inviolate and undiminished", in Art. VII, Sec. 6, Wyoming Constitution (quoted in Appendix, pp. 57-58).

† *Burnet* v. *Coronado Oil & Gas Co., supra,* 398.

therefrom. The States have kept faith. They do not and can not make these grants self-supporting. The practice in Wyoming is to place even the salaries of officials who administer these lands, along with all other expenses of supervision which they occasion, upon the general funds of the State, leaving the gross revenue available for the purposes of the grant.

Where the realization by the State of the value in these lands takes the form of leasing on a royalty basis, the specific duty of the State is to get the highest possible royalty out of the lease.* If the proceeds of operation accruing to a lessee are received by it tax-free, it can afford to bid a higher rate than if they are not, just as tax-exempt bonds sell for a higher price than those the interest return on which is subject to income taxation. (*Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 581, 582, 586). Only by keeping this leasing power entirely free from tax interference can the compact with the State be kept.

In the *Gillespie* case the compact by which the revenue-producing land was governed was between the United States and Indians, the United States describing its duties with respect to the land as those of a guardian for Indian wards. It would have been inconsistent with this relationship for the judicial branch of the government to permit others to lessen the effectiveness of that compact-grant.

The significant factor in these cases is not alone the existence of something that may be called a "trust", though in each of them a trust of some sort with respect to property or revenue existed. There was also, prior to the execution of the lease, a trust in *Group No. 1 Oil Corp.* v. *Bass*, 283 U. S. 279, but there the trust *res*, being Texas lands never owned by the United States, had never become the subject of any compact to which the federal government was a party.

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* This duty is expressly embodied in Section 712, Wyoming Compiled Statutes, 1920 (printed in Appendix, pp. 60-61).

This reason is in addition to the rule of Texas law which there operated to sever the oil from the land and so to cut off any continuing title, trust or otherwise, of the State. *Burnet* v. *Harmel,* 287 U. S. 103, 109. The traditional distinction between proprietary and governmental functions is helpful in this problem but not completely determinative. In the *Jergins Trust* case, *supra,* a discussion of this distinction makes clear the phase of the question there involved. It is to be kept in mind that in the *Jergins Trust* case the property covered by the oil lease, though originally acquired by a city for the use of part of its surface and some of its subsurface strata for water, it had largely ceased to have any water uses, and that its deeper oil strata involved in the case had never had any significance to the city on any other than a purely proprietary basis. Moreover, the faith of the United States was never there committed to the protection of any fund.

THE IMPOSITION OF A FEDERAL TAX UPON WYOMING ASSOCIATED WOULD IMPOSE A DIRECT BURDEN UPON THE STATE OF WYOMING.

Petitioner urges that the imposition of a federal tax on the income of Wyoming Associated from Section 36 would not impose any direct burden on the State of Wyoming (Pet. Br., 18-19).

Whether the lease covering Section 36 be viewed as held and operated by Midwest as a trustee, or as owned by it and Wyoming Associated substantially as co-lessees, a distinction which we discuss in detail later in this brief, there would plainly be such a burden. If the relationship between Wyoming Associated and the State of Wyoming is direct, there is an obvious direct burden within the rule of the *Coronado* case. If we accept the petitioner's view that Midwest operated the entire lease and that Wyoming Associated was the beneficiary of a trust established by the

declaration of a trust of February 1, 1923, there is just as immediate a burden. Obviously, Midwest, acting pursuant to this so-called trust, must consult the beneficiary in entering into any lease, or at the very least, determine on its own responsibility the interests of its beneficiary. The moment Midwest either consults Wyoming Associated or considers its interests as beneficiary, the very burden which induced this Court to rule in the *Coronado* case that the income from State lands is exempt, comes into operation.

If the solution of this tax exemption problem is to be sought in practical results rather than in technical relationships (Pet. Br., 37, 38), the facts of this case meet the practical test. If in the deliberation between the trustee-bidder and its beneficiary-joint-operator, the parties are forced to decide that the proceeds going to the beneficiary are taxable, the bid must be figured on that basis. Proceeds half taxable or all taxable are the same in principle; the result is a lower bid. For this very practical reason, the entire lease, whether issued to one who operates entirely for himself, or to one who takes as trustee for a group, or to one who has no personal interest, acting merely as agent for a principal, is burdened by the imposition of a tax upon the income of either or both participants in it. The entire lease is the instrumentality of the State, and any tax upon the proceeds of such a lease will lessen the effectiveness of the instrumentality. Interests carved out by sub-lease, *after the lease* has issued, leaving the fundamental relationship of the State to the operation unchanged, present an entirely different question.

Petitioner ignores this vital distinction between factors which, because they exist when a lease bid is made, influence the rate of royalty to be received by the State, and factors which do not then exist, and hence, if they later come into existence, cannot change a subsisting lease. His argument (Pet. Br., 19), of no practical burden in the instant case, is based upon the erroneous assumption that Wyoming Asso-

ciated acquired its interest in the lease from Midwest after the lease came into existence. We shall point out in more detail (*infra*, p. 21) that the facts are exactly opposite.

At another place petitioner (Pet. Br., 38) tries to brush aside all practical considerations by asserting that the royalties bid by applicants for State leases are just based on geologic hopes and not on any consideration of probable expenses and results! The argument that the State will not suffer because those engaged in producing oil are lacking in business foresight is gratuitous. In any event, the facts here reveal very little opportunity for the exercise of talents of this sort. These State leases were of five-year terms. This particular lease followed thirteen years of operation and development of this identical tract of land under three earlier leases (R. 125, 131, 136, 141). The Salt Creek field was, in 1923, a well recognized developed field (R. 59), and finally the rate of royalty actually bid of 65% of gross production is far above any recognized or conventional rate of royalty in that or any other field.

ON THE ASSUMPTION THAT WYOMING ASSOCIATED WAS A BENEFICIARY OF A TRUST, THE INCOME FROM SECTION 36 RECEIVED BY IT AS BENEFICIARY WAS TAX EXEMPT.

In a later subdivision of this brief we shall contend, in line with what the court below stated in its opinion (R. 156) that Wyoming Associated was "in substance and effect" as much "a lessee of the lands (Section 36 covered by the school lease) as was the Midwest Oil Company, the lessee in name". Before passing to that point, however, we shall examine the results which would flow from the opposite inferences of fact contended for by the petitioner.

In his brief petitioner says (Pet. Br., 15): "The State has given Wyoming Associated no rights, and Wyoming Associated has assumed no obligations toward the State."; and again, (Pet. Br., 16): "It is unnecessary to decide

whether this instrument (the declaration of trust, R. 111) creates a trust interest in the lease or only in the net proceeds. In neither case does Wyoming Associated derive its income from the State or from the state oil land."; and again (Pet. Br., 20): "Here Wyoming Associated made no payments to the State, * * *. It did not operate the property, * * * the income from the lease is derived without its aid."; and finally, (Pet. Br., 23): "The lease contemplated that Midwest would (1) extract the oil, (2) deliver 65 per cent. of it to the State, and (3) sell it. Only after these three steps had been taken would Wyoming Associated be paid its share of the benefits and net proceeds".

Where does this argument lead? It means that the State lease was held and operated by Midwest *as a fiduciary,* and that Wyoming Associated received its half of the proceeds of the State lease *as a beneficiary of a trust.* If that be the case, these proceeds of production from the State lease were received by Midwest as fiduciary, and should be dealt with under Section 219 of the Revenue Act of 1926,* in force in the year 1925. It follows that the exemption established by the *Coronado* case applied to the income from the State lease as it came to Midwest *as trustee,* and the question here to be determined is the status of such income when passed on by a trustee to Wyoming Associated *as a beneficiary.*

The effect of Section 219 of the Revenue Act of 1926, effective for 1925, is that exempt income received by a trustee and passed on to a beneficiary is not taxable in the hands of the beneficiary. To state this point in greater detail, Section 219, subdivision (a), provides that the tax imposed by Parts I and II of Title II shall apply to the income of estates or of "any kind of property held in trust", including four classes, the one material to the present discussion being class (2), consisting of "income which is to be distributed currently by the fiduciary to the benefici-

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* This section is printed in full in the Appendix, pages 53-56.

aries * * *". The reference is obviously to taxable income. But if there be any doubt on this point, it is made clear by subdivision (b) of Section 219, which states that, except as provided in subdivisions (g) and (h) (not material to the present discussion) "the tax shall be computed upon the *net income* of the estate or trust, and shall be paid by the fiduciary". (Italics ours.) This reference is plainly to net income as defined in Section 212(a), which is "gross income, as defined in Section 213, less the deductions allowed by Sections 214 and 206". "Gross income", by the operation of Section 213(b), amplified by Article 71 of Regulations 65 and 69, excludes from the very starting point of this computation all "income exempted by statute or by fundamental law." The statute then goes on, in Section 219 (b) (2), to place the duty of paying the tax upon the *beneficiary* instead of upon the *fiduciary* when the income "is to be distributed currently by the fiduciary to the beneficiaries". The mechanism of this subsection is to allow the fiduciary a special deduction for currently distributable income, with a requirement that the beneficiary take up the amount of the deduction in his return. No new definition of income is introduced and obviously the term continues to mean income of a non-exempt character coming within the concept of "gross income" as used in the earlier part of this section.

Thus, the statute adapts to trusts the general scheme of taxation adopted in the Revenue Act of 1926 for individuals. The trust is taxable upon income not currently distributable by it, and the beneficiary is taxable with respect to income distributable (*Freuler, Adm.* v. *Helvering*, 291 U. S. 35) but no tax is contemplated upon any one, whether fiduciary or beneficiary, with respect to what is not "gross income" as defined in Section 213 of the Act. The State lease income received by Midwest as trustee, and passed on to Wyoming Associated, is not "gross income", and is not taxable to the trust estate. Nor is it taxable to the beneficiary when passed on to it. The State land income is, in the words

of Article 71 of Regulations 65 and 69, one of those "items of income exempted by statute or by fundamental law."*

In other words, if Wyoming Associated received its share of the revenue from the school lands under the terms of the trust, the only conceivable provision in the revenue act which might subject this distribution to tax in the hands of Wyoming Associated is Section 219. But Section 219 makes it plain that the amount in question is not taxable income. In this case there was no income (that is, gross income, as defined in the statute and regulations, of the estate or trust), and, therefore, there could be no taxable income to the beneficiary.

This result, flowing from the petitioner's interpretation of the facts in this case, is no strained or technical result. It is an ordinary instance of the universal practice. The trust department of a bank holds state and municipal bonds in trust for an ordinary citizen. Whether the proceeds of coupons be accumulated or currently distributed, no tax is paid either by the fiduciary or by the beneficiary. "Fundamental law" renders these proceeds tax exempt, and that quality excludes them from "income" in the tax sense. This immunity follows the proceeds into the hands of the beneficiary.†

This Court dealt with an analogous, but more debatable, situation in *Helvering* v. *Falk,* 291 U. S. 183. In that case the question involved was the right of beneficiaries of a trust to depletion with respect to royalties from an iron-ore mine. The royalties were collected by the trustees of the trust and currently distributed to the beneficiaries. It was held that

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* The same or a similar statement appears in other regulations. See Reg. 45, 62, Art. 71; Reg. 74, 77, Art. 81; Reg. 86, 94, Art. 22 (b)-1.

† This rule is fully recognized by the Commissioner; see Reg. 69, 65, Art. 83 (a), Art. 344. See also *Carson Estate Co.* v. *Commissioner,* 31 B. T. A. 607; G. C. M. 5138, CB VII-2, 54; IT 1641, CB II-1, 76.

the beneficiaries were the owners of the entire economic interest in the mine and as such were entitled to a deduction for depletion under the Revenue Acts of 1921, 1924 and 1926. The Commissioner argued that since Section 219 of the Revenue Act of 1924 expressly required the beneficiary to include in his return the portion of the income of a trust distributed to him, he is to be subjected to taxation on the whole amount to be distributed regardless of depletion. In rejecting this line of argument, this Court said, at page 189:

> "* * * But we cannot accept the view that this [the direction in Section 219 (b) that in cases of income which is to be distributed currently to the beneficiaries the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary] was intended to impose a tax upon that part of the proceeds which represents the return of capital assets, whenever this has been paid over to the beneficiary. In cases like the one before us so to hold would in practice result in taxing allowances for depletion, contrary to what we regard as the plain intent of the statute. * * * the trustees must be regarded as a mere conduit for passing them [proceeds of oil] to the beneficial owners. Part only of the proceeds was subjected to taxation. The other part was left untaxed and remained so in the hands of the beneficiaries."

The same conclusion is *a fortiori* in the instant case since the question is not a matter of deduction governed by statute, but is a matter of complete exemption, which is a constitutional matter. Thus, assuming that Midwest, the trustee, was the only direct lessee of the State, nevertheless, Wyoming Associated's (the beneficiary's) share of the income from such lease came to it *via* the trustee, which trustee, to use the term used by this Court in *Helvering* v. *Falk, supra,* was a mere "conduit"—to use the term used by this Court in *Douglas* v. *Willcuts,* 296 U. S. 1, 9, a mere "channel"—for the transmission of this exempt income to the beneficiary.

The decision of this Court in *Stone, et al., Trustees,* v. *White,* 301 U. S. 532, develops the underlying purpose of this statutory scheme for the taxation of trustee and beneficiary. There a trustee sought refund of a tax erroneously paid by it on income which should have been taxed, but was not taxed, to the beneficiary of the trust. This Court, after pointing out that an action to recover taxes, although at law, is equitable in its function, applied to the utmost the principles for which we are here contending. The Court said at pages 535-536 (italics ours):

> "In the present case it is evident that but a single tax was due upon the particular income assessed and that petitioners' demand arises from the circumstance that the tax was paid from the income by the trustees when it should have been paid by the beneficiary. If the court may have regard to the fact that so far as the equitable rights of the parties are concerned *petitioners, in seeking recovery of the tax, are acting for the account of the beneficiary,* it would seem clear that the case is not one in which the petitioners are entitled to recover *ex aequo et bono;* for under the construction of the will by the court below, which we adopt, any recovery in this action will be income to the beneficiary, and will deprive the government of a tax to which it is justly entitled and enable the beneficiary to escape a tax which she should have paid.
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> "It is said that as the revenue laws treat the trustee and the beneficiary as distinct tax-paying entities, a court of equity must shut its eyes to the fact that in the realm of reality it was the beneficiary's money which paid the tax and *it is her money which the petitioners ask the government to return.* Formerly, trustee and *cestui que trust* were likewise distinct in the eyes of the law, as they are today for many purposes. But whenever the trustee brings suit in a court which is free to consider equitable rights and duties, his right to maintain the suit may be enlarged or diminished by reference to the fact that the suit, *though maintained in the name of the trustee alone, is for the benefit and in the equitable interest of the cestui.*"

In the instant case it is respectfully urged that a court of equity should likewise take "cognizance of the identity in interest of trustee and *cestui que trust*" (p. 537). Such a conclusion is necessary as well to protect a solemn exemption as to protect the revenue.

WYOMING ASSOCIATED WAS IN SUBSTANCE A DIRECT LESSEE OF THE STATE OF WYOMING, OR A CO-LESSEE OF SECTION 36.

So far we have dealt with the question at issue on the basis of petitioner's assumption that there was no privity of contract between the State of Wyoming and Wyoming Associated. We shall now examine this assumption to see whether it can fairly be said that Midwest, and not Wyoming Associated, is to be treated as the real lessee of this half of the lease.

In the first place, uncontroverted evidence offered at the trial negatives any such assumption. It was shown at the trial that the oil produced from Section 36 (the State school section) was first collected into battery tanks where it was steamed and the impurities taken out (R. 61); that Wyoming Associated had a man employed at these battery tanks to gauge the oil and by his signature on run checks to make delivery of the oil to the gathering lines of the pipeline company (R. 61); that from the battery tanks the State of Wyoming's share of the oil was delivered to its nominee and the remainder of the oil divided equally between Wyoming Associated and Midwest (R. 61). Wyoming Associated received payment for its half of the oil direct from the purchaser, the Refining Company (R. 61, 115).

Not only did the State of Wyoming take delivery of the oil from Wyoming Associated, but testimony was offered at the trial by a person present at a conference between representatives of the State of Wyoming and representatives of Wyoming Associated relative to the leasing of Section 36 shortly before the lease of April 29, 1923, was made (R. 65). This conference, held at Cheyenne, Wyoming, in the early

part of April, 1923, was presided over by Governor Ross of the Wyoming State Land Board, and was attended by Mrs. Martin, Superintendent of Public Instruction of the State of Wyoming, and two or three other members of the Wyoming State Land Board (R. 65). Mr. Barnett, President of the Wyoming Associated, was present on behalf of that company (R. 65). The conference was in the nature of a public hearing, and was brought about by the Land Board of the State of Wyoming, to invite proposals for a renewal of the lease some eighteen months in advance of its expiration date (October 1, 1924) (R. 65). Wyoming Associated, through its president, Mr. Barnett, objected at the hearing to this procedure, arguing that it would have the effect of forcing Wyoming Associated, as well as Midwest, to bid higher royalties than they might have had to meet if the matter had been permitted to wait until a time nearer the expiration date of the lease (R. 65).

This last line of testimony offered at the hearing before the Board of Tax Appeals was objected to by counsel for the Commissioner, and was stricken out "for the reason that it is incompetent, irrelevant, and immaterial and an attempt to alter or vary the terms of a written instrument, a copy of which was attached to the stipulation of facts as Exhibit U-1". Counsel for respondent noted and was allowed an exception (R. 65-66) and urged this error in the Circuit Court of Appeals (R. 51).

Plainly this evidence shows direct dealings between Wyoming Associated and the State of Wyoming. It shows that in substance the Wyoming Associated was a co-lessee of Midwest actively operating a one-half interest in the State lease. Wyoming Associated was, therefore, in all respects an instrumentality or direct agency of the State, and in its own right was entitled to the exemption recognized in the *Coronado* case.

The rejected evidence was admissible, since the controversy was not between the parties to the instrument, but between one party to an instrument and a third party,—the Commis-

sioner of Internal Revenue.* Taking this excluded evidence in connection with the evidence to which no objection was made, that the State of Wyoming accepted deliveries of royalty oil, which it re-sold to the White Eagle or Empire Oil Companies (R. 66), the inference is irresistible that there was in practical fact privity of contract between the State of Wyoming and Wyoming Associated, and that the lease of Section 36 was in substance a joint lease to Midwest and Wyoming Associated, taken as a matter of convenience in the name of the Midwest Oil Company with full knowledge on the part of the officials of Wyoming that Wyoming Associated was in substance, though not in name, a party to the lease.

Even if Wyoming Associated be not regarded as appearing through its own officers at hearings on the issuance of the State school lease, nevertheless it would still be far from occupying a status analogous to that of a sub-lessee. If it was not represented by its own officers in the State leasing negotiations, it was certainly represented by Midwest, which thus acted as its agent. A corporation, being an artificial entity, must always act through others. What difference does it make whether it acted through the agency of its own officers or through the agency of another corporation?

Even if all evidence of direct dealings between the State of Wyoming and Wyoming Associated be ignored, the history of the State lease covering Section 36 plainly supports the holding of the Circuit Court of Appeals,—that Midwest and Wyoming Associated were:

> "* * * bound together by a trust agreement entered into before the lease by the State was made by which they were to have equal rights in the lease itself and the net proceeds realized from it in whichever name of the parties the lease or any renewal or extension should stand." (R. 156);

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* *Peugh* v. *Davis*, 96 U. S. 332; *E. C. Gatlin* v. *Commissioner*, 34 B. T. A. 50; *Appeal of Converse & Co.*, 1 B. T. A. 742; *Appeal of J. W. Solof*, 1 B. T. A. 776.

and that—

> "* * * In substance and effect the Wyoming Associated was as much a lessee of the lands as was the Midwest Oil Company, the lessee in name" (R. 156).

The Wyoming Associated's interest in the State school lease did not originate with the declaration of trust of February 1, 1923, but was one of the items of property acquired by it in the corporate reorganization out of which, in 1919, it arose (R. 57, 58; Ex. L-2, R. 99-100).

The particular lease in effect in 1925 was the fourth in a series of consecutive State school leases dating back to January 4, 1910 (R. 59), each of which, after the first, was in effect a renewal of the preceding lease, rates of royalty being fixed, when each renewal was granted, by public competitive bidding. Petitioner asserts that in Wyoming the lessee under these State school leases as they expired had no option of renewal (Pet. Br., 12). This assertion requires some qualification. At all times involved in this case, Wyoming, by statute,* recognized a preference right over other bidders in the securing of a new lease as attaching to the lessee whose term was expiring. The practical operation of this preference is intensified by other statutory provisions† protecting the investment of the old lessee in improvements on a lease in the event others should, by outbidding him, secure the renewal. A regulation of the Wyoming Board‡ admin-

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* Ch. 62, C. L. Wyoming, 1921, amending and reenacting Sec. 712 Wyoming Compiled Statutes, 1920. This section is printed in full in Appendix, pages 60-61.

† Section 718, Compiled Statutes, Wyoming, 1920, which is the same statute as that referred to in Paragraph 10 of the State school lease Exhibit U-2 (R. 131, 134). The text of this section as it now appears without significant intervening amendments as Section 91-804, Wyoming Revised Statutes, 1931, is printed in full in the Appendix, page 61.

‡ Regulation 75 of the Board of Land Commissioners, promulgated June 4, 1919. The full text of this regulation is printed in the Appendix, page 61.

istering these leases interprets this latter statute as giving in practice preference rights.

The first in this series of State leases (R. 141) was taken by a mining partnership of 19 members (R. 54). William Fitzhugh was the lessee named in this lease and he held it for the benefit of the partnership (R. 54). In 1911 Fitzhugh and one other member of this partnership assigned their interests in this lease to Midwest (R. 54). Later in the same year, Reed Investment Company acquired (R. 54) and took over (R. 146) from the other 17 members of the partnership their interests in the first State school lease. By an instrument of partition (R. 78) entered into between the dates of these two purchases, Midwest and Reed Investment Company agreed to segregate their respective interests in the section of land covered by this State school lease, a specific 240 acres to the former and a specific 400 acres to the latter. In 1912 Reed Investment Company was succeeded by California Oil Company (R. 55), and in June, 1919, the segregated interest of California Oil Company in the second school lease (dated December 26, 1914, and naming Midwest as lessee (R. 136)) was among the items of property going to Wyoming Associated (R. 57, 110). The third State lease, dated October 1, 1919, was issued in the name of Midwest (R. 131). On February 1, 1923, before this third lease had expired, Midwest and Wyoming Associated agreed to change their respective interests in this school section from segregated parts of it into undivided interests of equal size. This was part of a field program of avoiding excessive offset drilling (R. 58, 59). On the same date, February 1, 1923 (R. 59), the declaration of trust (R. 111) was entered into between Midwest and Wyoming Associated. The reference in this document to its superseding all other definitions of interest is explained in oral testimony before the Board (R. 62) as a reference to the 1911 partition agreement (R. 78) which had created the segregated tract operations.

This, in condensed form, is the background of the issuance on April 19, 1923, of the fourth State lease (R. 125), at an increased royalty of 65%, by the State of Wyoming to Midwest as nominal lessee. The interest of Wyoming Associated in the State lease was, therefore, of equal age and dignity with the fractional interest owned by the Midwest.

While Midwest was the nominal lessee from the State of Wyoming with respect to the entire section, and thus in a technical sense may be said to hold legal title to the lease, Wyoming Associated and its predecessors in interest possessed and dealt directly, prior to February 1, 1923, with a specific 400 acres, and subsequent to that date Wyoming Associated possessed and dealt directly with an undivided 50% interest in the entire section. The declaration of trust (Ex. N; R. 111), acknowledged formally this long-standing coordinate interest which Wyoming Associated and its predecessors in interest had held in this lease. The language of the trust instrument itself is not without significance. It says in part that (R. 112):

> "* * * The Midwest Oil Company doth hereby declare that it holds an undivided fifty per cent (50%) interest in said lease and in the benefits and net proceeds to be realized therefrom and all renewals and extensions thereof for the use and benefit of said The Wyoming Associated Oil Corporation, and reserves the beneficial interest in the remaining fifty per cent (50%) thereof to itself.
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> "And in consideration of the creation of the foregoing trust, said The Wyoming Associated Oil Corporation hereby covenants that it will share all of the burdens and obligations hereafter accruing under said lease with The Midwest Oil Company in the fractions hereinabove set forth, and that in the event any renewal or extensions of said lease should be made in the name of The Wyoming Associated Oil Corporation, or in their joint names, then the interest thereunder shall be held by the recipient of said lease in trust for the benefit of itself and the other party hereto in the fractions hereinabove set forth."

While a formal relation of trustee and beneficiary may be established by the declaration of trust, the beneficiary covenants for an equal share of the "burdens and obligations hereafter accruing under said lease" (R. 112); and the instrument goes on to say, very pointedly, that if any renewal or extension of the lease is made, either in the name of Midwest or Wyoming Associated, the party in whose name the lease is taken will hold the lease for the benefit of the other party, to the extent of the other party's half interest therein. Nothing could reveal more clearly the true nature of the transaction or show how unimportant the technical form really was. *Palmer* v. *Bender*, 287 U. S. 551. Whether the lease was taken in the name of one party or of the other, or of both, was of no consequence.

In support of the opposite theory, that Wyoming Associated did not enjoy the status of a joint lessee, petitioner asserts (Pet. Br., 17) that Wyoming Associated "purchased the right to share in the profits realized by Midwest by surrendering more or less similar interests which it or its predecessors had possessed since the original Fitzhugh lease". This is indeed a triumph of form over substance. If we understand petitioner correctly, he claims that even if Midwest and Wyoming Associated were joint lessees in this State school lease prior to February 1, 1923 on the basis of Midwest owning and operating a segregated 240 acres and Wyoming Associated owning and operating a segregated 400 acres, the essence of this relationship would be lost if, to avoid offset drilling, they agreed that from and after February 1, 1923, each would own an undivided one-half interest in the entire lease. Out of this exchange of a segregated for an undivided interest in the identical property, petitioner spells an *acquisition* of its interest in the lease by Wyoming Associated from Midwest!

We may pass over this technical argument because, whatever its merits, this so-called "purchase" spent its force with the expiration of the State lease then in effect. This oc-

curred October 1, 1924, before the commencement of the tax year in question. As noted by the court below, when the lease dated April 19, 1923, which governed the taxable year 1925, was taken by Midwest, it and Wyoming Associated were already bound together by the terms of a declaration of trust through the operation of which the interest of Wyoming Associated in the lease came into existence at the very commencement of the lease by operation of law and was in no sense acquired by it from Midwest. This interest cannot, even on technical grounds, be viewed as a subordinate, derivative, or inferior interest of any sort.

The petitioner points out (Pet. Br., 15) the absence of any assignment of a 50% interest in the lease of April 19, 1923 from Midwest to Wyoming Associated. There was no occasion for anything of the sort. The declaration of trust preceded the lease. To the extent of a 50% interest Midwest acquired the lease as an agent or as a trustee; the consideration for the lease—the agreement to pay the Wyoming school fund a royalty of 65%—moved in equal parts directly from the two equitable co-owners, and in substance they stand, from the instant this lease came into existence, upon exactly the same plane, one with the other. The State school lease, with respect to each, is the instrumentality through which the State of Wyoming performs its duty,—a duty imposed by Congress in the land grant portion of the Act of Admission and accepted by the Constitution of Wyoming, to utilize the proceeds of this land "for the exclusive benefit of the public schools * * * forever inviolate and undiminished".

We have shown, from the long history of the State lease and from the relations between the parties revealed in the declaration of trust itself, that Wyoming Associated was a real party in interest with a direct interest in the lease itself. In view of these facts, it is respectfully urged that the terms "trustee" and "beneficiary" are either completely inappropriate as applied to Midwest and Wyoming Associated, or the terms must be understood as related to a dry,

naked and passive trust in which the trustee has no duties as such, and the beneficiary holds direct enjoyment of the property. See *Lewis & Co.* v. *Commissioner,* 301 U. S. 385, 388.

The purpose of tax laws, and certainly of the federal income tax, is to impose the burden of taxation upon the real owner of the income. This well established rule in connection with the burden of the tax is equally well established in determining who shall receive exemption in the case of tax-free income. This simple principle should control the decision in the instant case. *Bettendorf* v. *Commissioner,* 49 F. (2d) 173 (C. C. A. 8th); *Central Life Assurance Society of the U. S. Mutual* v. *Commissioner,* 51 F. (2d) 939 (C. C. A. 8th).

THE WANLESS AND HOBART CASES ARE NOT APPLICABLE.

The respondent has no quarrel with the principles established by many of the cases cited by the petitioner in his brief on the State land point. Most of these cases do not touch the issue in the instant case. It is desired, however, to point out in careful terms the distinction between the instant case and the decision of the Eighth Circuit Court of Appeals in the *Wanless Iron* case, *supra,* and the decision of the Sixth Circuit Court of Appeals in *Hobart Iron Co.* v. *Commissioner,* 83 F. (2d) 25 (C. C. A. 6th), certiorari denied 299 U. S. 543. It is argued by the petitioner (Pet. Br., 20, 25, 30) that under the doctrine of these cases, Wyoming Associated did not hold the lease directly from the State of Wyoming and that the *Coronado* doctrine is inapplicable.

In the *Wanless* case the lease issued by the State had been first assigned and then parcelled out by the assignee, Wanless Iron Company, to operating sublessees. The income which the taxpayer, Wanless Iron Company, received, in the language of the court was (p. 781) "not from an actual operation of the mines, but in the form of royalties received in turn from its sublessees". These sublessees paid

the State its full royalty directly, and in addition, under the terms of the subleases, paid the taxpayer an intermediate profit. The court likens the situation to that in *Willcuts* v. *Bunn,* 282 U. S. 216, where this Court had drawn a distinction, for tax purposes, between profits realized on the sale of municipal bonds, and the coupon yield of the bonds themselves. Under these circumstances, it was entirely proper, in the *Wanless* case, to hold that there should be no tax exemption.

In the instant case Wyoming Associated made its own royalty settlements with the State of Wyoming by making delivery *to the State's nominee* of royalty oil in kind. It sold its fraction of the oil remaining direct to the Refining Company and collected its part of the proceeds without any intervention of Midwest with respect thereto (R. 61). The arrangement between Midwest and Wyoming Associated was in no sense an assignment under which the assignee received income from any sublessee. Midwest retained no intermediate royalty as did the Wanless Iron Company.*

The same underlying distinction disposes of the decision of the Sixth Circuit Court of Appeals in *Hobart Iron Co.* v. *Commissioner, supra.* There a mine belonged to the State of Minnesota; the State leased the mine to Sullivan and Hale for 50 years for a royalty of 25 cents per ton of iron ore mined. Sullivan and Hale subleased the mine to the taxpayer for the lesser term of 44 years, the taxpayer agreeing to pay Sullivan and Hale a royalty of 10 cents on each ton

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* In *Ohio Oil Company* v. *United States,* 1936 C. C. H., Par. 9415 (D. C., N. D. Ohio, W. D.), unreported elsewhere, this distinction between a beneficiary and trustee relationship and the sublease relationship of the *Wanless* case is adopted. In the *Ohio Oil* case the lease was taken in the name of a person who held it from the beginning in trust for the taxpayer. The court held that this did not take the case out of the rule of the *Coronado* case. The land was Wyoming State school land. Taxpayer's income was held exempt.

of ore mined. The taxpayer in this case was a *sublessee of a lessee* from the State of Minnesota. As the terms and royalty rate of any such sublease are of no concern to the State, its underlying royalty fixed by the original lease remaining unchanged, there is no burden on the State in having the profits of a sublessee held taxable. In the instant case, there being no sublessee relationship on any theory, the royalty rate which the State is able to obtain on a lease and on successive renewals will rise or fall depending on whether the bidder can count on tax exemption. Whether the bidder deals directly or bids through a trustee makes no difference in practical result.

POINT II.

"The gross income from the property", within the meaning of Section 204(c)(2) of the Revenue Act of 1926 on which the 27½ per cent depletion allowance of Wyoming Associated should be computed, includes not only the cash part of the sale price of its oil, but also the value of services received by it from the Refining Company under the contract.

Summary and Scope of the Argument.

Wyoming Associated sold the oil from its properties* to the Refining Company under a contract which expressly required the Refining Company to perform certain services

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* The point in this case dealing with exemption of State school lease income has only this one point in common with the depletion point now under discussion: The school lease gross income and unreturned cost are separately determined by the Board (R. 36, 37, 38) and petitioner does not claim to be entitled to both exemption and depletion upon the income from that particular lease.

"as part of the price for oil purchased" (R. 120). The gross income from the property of Wyoming Associated for percentage depletion purposes, therefore included the value of these services. This express provision of the contract was a natural and proper term expressing the actual transaction between the parties. By reason of the date upon which the contract was written no motive of tax avoidance could have been present. No conflict exists between the decision of the court below and the *apportionment of depletion* cases noted in the petition for certiorari. The petitioner in fact concedes that the Refining Company had no depletable interest in these leases.

As to subdivision II-B of petitioner's brief (Pet. Br., 51) in which he seeks now to question the measure of value to be applied to these services, we submit his discussion falls outside the scope of this review and should be disregarded. This measure of value was embodied in a stipulation before the Board, was found by the Board to be the correct measure of value for use if any value representing the services is to be included in gross income, and it was not challenged by petitioner either in the court below or in his petition for certiorari.

GROSS INCOME FROM THE PROPERTY INCLUDES VALUE OF SERVICES WHICH ARE BY EXPRESS CONTRACT MADE PART OF THE SALE PRICE OF THE OIL.

The question before the Court is the proper construction of Section 204(c)(2) of the Revenue Act of 1926, which provides that a reasonable depletion allowance shall be "27½ percentum of the gross income from the property" during the taxable year, provided, *first*, that the allowance shall not exceed "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property", and, *second*, that the allowance shall not be less than it would be without reference to this paragraph. No question as to the applicability of either of these two

qualifications is presented.* The sole question is the proper meaning of the phrase "gross income from the property", used in Section 204(c)(2). More precisely stated, the question is whether the term "gross income from the property" is to be limited to cash actually received, or may include income received, constructively or otherwise, in the form of services.

The term "gross income", as used in Section 204(c)(2), is to be taken in the same broad sense in which it is defined in Section 213† for the purposes of the entire income tax *title*. The statute, for the obvious purpose of protecting

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* On page 40 of his brief petitioner makes the somewhat confusing statement that "Before the Board the respondent also relied on depletion based on cost in lieu of percentage depletion (R. 22, 32, 45)." This relates to separate lease tracts other than those upon which respondent claimed, and was allowed, under the opinion of the court below, percentage depletion. Exhibit V to the stipulation of facts (R. 145) lists the 43 separate lease tracts (other than the state school lease) owned by Wyoming Associated in the tax year 1925. In the proceeding before the Board respondent established the cost of these properties segregated by tracts. This was a higher cost than that first conceded by the Commissioner in the deficiency notice. As to this Board determination of cost no appeal was taken by either party. In the recomputation of tax under Board Rule 50, which resulted from the Board's decision, respondent was given the benefit of cost depletion on specific leases with respect to which cost gave higher depletion than the percentage depletion computed by the Board. The appeal to the Circuit Court of Appeals was, and consequently this review is, concerned only with those particular leases upon which percentage depletion, as computed under the legal theories of the Board, is higher than cost depletion, but lower than percentage depletion would be if the elements of income contended for by respondent are recognized. As all these additional elements of income are segregated in the stipulation by separate tracts, there is no difficulty in applying the correct rule of law to the respective leases when that rule of law is established.

† See petitioner's brief, page 48.

the revenue, reveals an intention on the part of Congress to reach pretty much every sort of income subject to the federal power.* The statute speaks of income as including "gains or profits and income derived from any source whatever."

Having adopted this term "gross income", to the comprehensive definition of which a whole section of the Act is devoted, as a basis for percentage depletion, it is to be presumed that Congress meant, in Section 204(c)(2), to allow depletion upon the basis of the same broad concept of income. Any decision narrowing the definition of the term "gross income", as used in Section 204(c)(2), will have its inevitable repercussion upon the concept underlying Section 213.

The Court below took the position, urged by respondent, that the gross income from the property during the taxable year consisted not only of the cash payments from the Refining Company to Wyoming Associated, but also of the cost of production expended by the Refining Company under its contract (Ex. T-2, R. 118) which provided that these production costs should be a "part of the price for oil purchased" (R. 120). The Court below saw no "just or logical reason" why this cost of production, which was expressly made a part of the purchase price by contracts antedating the enactment of the Revenue Act of 1926, in which percentage depletion was first allowed, should not be added to the cash payments for the purpose of determining gross income. The Court goes on to say (R. 154):

> "Certainly it should be unless pure technicalities of the taxing laws be invoked. Had the Wyoming Company produced the oil at its own expense, its gross income would have been the amount which it received from the oil sold and the only difference would have been that it would have received in cash the propor-

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* *U. S.* v. *Safety Car Heating & Lighting Co.*, 297 U. S. 88, 93.

tionate amounts which represented the cost of production. Under such conditions there should be no question of its gross income including the oil produced and sold to cover production costs. It cannot logically be less than an element of gross income because the cost of production by another is a component part of the purchase price of the oil. There is no criticism on the part of the Government either as to the fairness of the purchase price or of the cost of production covered by the contract between the Wyoming Associated and the Midwest Refining and therefore it would seem unnecessary to analyze these schedules; nor can any charge be made that there was any effort on the part of the taxpayer to enter into a contract for the purpose of favorably affecting its tax liability."

THE PRODUCTION SERVICES RECEIVED BY WYOMING ASSOCIATED WERE PART OF THE PRICE FOR OIL SOLD BY IT TO THE REFINING COMPANY, AND GROSS INCOME OF WYOMING ASSOCIATED FROM THE PROPERTY; IT IS THEREFORE IMMATERIAL THAT SUCH SERVICES WERE PERFORMED BY THE REFINING COMPANY, NOT ONLY FOR WYOMING ASSOCIATED, BUT ALSO FOR ITS OWN BENEFIT.

Petitioner contends throughout Point A of the second division of his brief (see pp. 41, 42, 47), that the production operations performed by the Refining Company cannot constitute "gross income" to Wyoming Associated for the reason that such services were performed by the purchaser "for his own benefit" (Pet. Br., 42). It is not claimed by petitioner that services may not constitute gross income. On the contrary, petitioner admits that one who exchanges a share of stock for the services of a physician "may realize income based on the difference between the cost or other basis of the stock and the value of the services to him * * *" (Pet. Br., 42). It is argued by petitioner that the instant case does not fall within this admission,—that the services rendered by the Refining Company do not constitute gross income in the present case,—because, so the petitioner argues, the

Refining Company performed the services, received in the instant case by Wyoming Associated, *for its own benefit.*

Clearly, it is irrelevant that the Refining Company acted *for its own benefit.* The argument that motivation of self-benefit in the performer of the services necessarily excludes the services from being income to the recipient proves too much. It prevents the value of services from ever constituting income, and the petitioner admits in his doctor analogy that services may constitute income. All commercial and business transactions are carried on by each side for the purpose of obtaining self-benefit. Cash may be paid and commodities may be surrendered by a person intending to benefit himself. Such cash and commodities are none the less income to the recipient.

Obviously, we have to inquire more deeply into a transaction involving services if we would determine whether services constitute income. What is it that makes the services of the physician in petitioner's hypothetical case income to the recipient? As we have shown above, it cannot be lack of self-benefit to the physician, for benefit to him does accrue. The determinative fact is that the services are the consideration for the stock, just as in the instant case the services under discussion are part of the consideration for oil. Being part of the consideration paid for an article sold, they are part of the purchase price received. Being part of the purchase price received, they are part of the seller's gross income.

The fundamental thing which makes the services of the physician in petitioner's hypothetical case, and the services of the Refining Company in the instant case, part of the purchase price, is that they were agreed to be paid for something which has been sold or exchanged. The agreement of the parties is what makes a purchase price, and consequently determines gross income of the seller. This becomes apparent when we examine the language which does not fit the facts of the case, but which the petitioner has to employ, to

express his argument. He says (Pet. Br., 42) that "where, as in the present case, oil production operations are conducted by a purchaser *for his own benefit* in order to obtain the oil at a contract price which he may deem favorable, those operations are not income of the seller of the oil". It is noteworthy that in this statement the petitioner omits all reference to the vital fact that the purchaser had *agreed* to conduct these production operations in a contract providing for the sale of oil by Wyoming Associated, and that this agreement expressly provided (not in a "recital" as contended at p. 46 of petitioner's brief but in a substantive provision of the contract, R. 120) that the services would constitute part payment for the oil sold.

The decisive fact is not, as stated by petitioner (Pet. Br., 42), that the production operations were conducted by the Refining Company. The decisive fact is that the Refining Company *agreed* to conduct the operations in a contract which explicitly provided that the services should be part of the purchase price of the oil. The conducting of the operations merely carried out the agreement and constituted a performance of a contract for the sale of oil under which services were part of the purchase price. The provisions of the contract are plain, direct and simple, and read as follows (R. 120):

> "From the date of this Agreement until the First day of January, 1934, as part of the price for oil purchased hereunder, the Refining Company will drill, case, and maintain all wells, find and supply water, install and operate pumps when necessary, clean, shoot, and otherwise stimulate production of wells as necessary, and conduct all development and production operations upon said lands necessary or proper for the protection and conservation of the oil and gas contained therein and for the production of oil therefrom in such amounts and from such wells as will prevent the drainage of the oil content of said lands through wells belonging to other operators, and will, at all times during said term, maintain the development of and production from

> said lands at such rate that the production of oil therefrom shall be proportionate to the production of oil in other parts of the Salt Creek Field. * * *"

In other words, the services are to be performed by the purchaser "as part of the price for oil purchased hereunder".

When we come to examine the other clauses and provisions of the contract, we find that the words "part of the price for oil" were not chosen at random. They are in harmony with the actual arrangements for the sale and disposition of the oil. For example, Article III, Section 2, of the contract (R. 121) provides that the Refining Company "will take delivery of the oil purchased hereunder at the outlet gates of the measuring tanks located at or near the wells on said lands". Steaming for separation of water or the breaking down of emulsion is referred to later in the same Section. Obviously, this was a delivery of oil as chattel property, not only after severance from the land, but also after market preparation.

This same provision as to point of oil delivery governed risk of fire loss (R. 63). If a loss occurred prior to the passage of the oil through the tail gate of a measuring tank, it fell on Wyoming Associated, but if the loss occurred after the oil passed that point, the loss fell on the Refining Company and Wyoming Associated would be paid the full price for the oil.

In other words, Wyoming Associated agreed to sell and deliver oil to the Refining Company after it had been lifted from the ground and impurities had been removed from it. These services had to be performed prior to the delivery of the oil and the passage of title thereto. Prior to the signing of a contract the seller was under no obligation to employ the Refining Company to perform the services; it could have done the work itself or employed another company to do the work. In any event, the production and lifting services had to be performed by someone in order to enable the seller to make delivery of the oil. The seller chose as a matter of

convenience to have the purchaser perform these services for it. This it did by hiring the Refining Company to perform the services. It agreed to accept performance of this work "as part of the price for oil purchased".

In view of the services to be rendered by the purchaser, it is reasonable to suppose that that part of the contract price which the purchaser was obligated to pay in cash was fixed below an amount which would have represented the prevailing market prices of oil. This we find to have been the case in the taxable year in question (R. 37, 145).

Once we have arrived at the inevitable conclusion that under the circumstances of this case the value of the services was intended by the parties to constitute part of the purchase price for the oil, there is no more reason for refusing to regard the value of these services as part of the gross income of the seller than there is in the case in which the owner of stock sells his stock for physician's services, or than there is in refusing to recognize cash itself as a purchase price of oil if the parties have agreed upon a definite sum. A simple illustration will serve to fortify this conclusion.

Let us suppose that the Wyoming Associated had sold its oil supply from this particular set of wells, not for cash in any amount whatever, but solely in return for performance on the part of the Refining Company under a contract of all the producing services necessary to lift oil from *another* set of wells. In that case, it could not be contended that the value of these services did not constitute the gross income of Wyoming Associated from the first set of wells. What difference does it make whether the services are performed with respect to the first set of wells or with respect to another set of wells, so long as the services have a definite money and economic value to Wyoming Associated? If Wyoming Associated should modify such an agreement so as to provide for a cash payment for the oil from the first set of wells, in addition to the continued performance of the afore-

mentioned services, the *additional cash consideration* would not affect the result; the value of the services, specified by the contract as part payment for the oil, would continue to be part of the income of Wyoming Associated. It follows that if the agreement as *originally* made provided for a cash payment for the oil plus the services the result would still be that the value of the services are gross income to Wyoming Associated from the property.

By his use of an excerpt from *Eisner* v. *Macomber,* 252 U. S. 189, 207, petitioner, at page 42 of his brief, implies that only things of "exchangeable value" may be included in gross income for any purpose. There is no broad unqualified rule that a taxpayer has no income unless he receives something which he may exchange. This is settled by decisions of this Court (See, e.g., *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716; *United States* v. *Boston & Maine R. R.,* 279 U. S. 732; see also *Raybestos-Manhattan, Inc.* v. *United States,* 296 U. S. 60). In the first two cited cases this Court held that a taxpayer might receive taxable income in the form of a payment of taxes on its behalf. Such a payment is a substantial benefit, but it is nothing that may be assigned or transferred to someone else. It is also established by decisions of this Court that any reduction of liability constitutes taxable income (*United States* v. *Kirby Lumber Co.,* 284 U. S. 1; *Douglas* v. *Willcuts, supra*).

These principles are illustrated in the recent decision of this Court in *Helvering* v. *Midland Mutual Insurance Company* (300 U. S. 216). In that case the Court held that a mortgagee bidding in mortgaged property at a foreclosure sale at the amount of the principal of the mortgage loan plus accrued interest, and taking over the property in satisfaction of the whole debt *without payment and repayment of any cash,* was, with respect to interest included in the bid, in receipt of taxable income, even though the property, when acquired, might be worth less than the amount of the principal alone. The theory of the decision is that the mort-

gagee is not to be excused from paying tax because it received "a credit rather than money or other tangible property." In spite of the fact that the credit was not entered on the mortgagee's books as income, the Court viewed the transaction as if the accrued mortgage interest had been collected along with the principal, pointing out that the discharge of the debt included the interest accrued. The Court says (pp. 224-225):

> "* * * Where the stranger makes the purchase, the debt is discharged by a payment in cash; where the mortgagee purchases the property, the debt is discharged by means of a credit. The amount so credited to the mortgagor as interest paid would be available to him as a deduction in making his own income tax returns. It would be strange if the sum deductible by the mortgagor debtor were not chargeable to the mortgage creditor as income received. * * *
>
> "* * * There is nothing unfamiliar in taxing on the basis of the legal effect of a transaction."

This goes further than the instant case. The amount of production expense advanced by the Refining Company under its contract with Wyoming Associated, constituting expressly as it does, part of the purchase price of oil under that contract, is a much more substantial item of income than was the implied or constructive credit in favor of the mortgagor in the *Midland* case. Furthermore, this Court, in the *Midland* case, specifically recognized the deductibility of the credit by the mortgagor, who had paid nothing, but had merely surrendered his property in discharge of the mortgage debt.

The court below treated the decision in *Boulton* v. *Heiner*, 3 F. Supp. 372 (W. D. Pa.) as a precedent upon the point of recognizing services as constituting income under appropriate conditions. The court in the *Boulton* case was, as the court below states, confronted with a matter of determining whether or not the value of services under a contract should

be included with cash payments in fixing the cost of stock for the purpose of ascertaining the profit from the sale thereof. The court below then quotes from the *Boulton* case as follows (R. 154):

> "'The plaintiff claims in the present suit that in addition to the amount of money actually paid by him for the stock in question in order to acquire it, he was compelled by his contract with the other incorporators and with the original owners of the properties taken over by the corporations, to expend labor and effort which was worth at least the sum of $17,500. The uncontradicted testimony shows that this service was agreed upon and rendered; that it was worth $17,500; and that plaintiff received no compensation therefor other than by the right to acquire the stock. Under these circumstances it is our opinion that the plaintiff is entitled to claim that the cost of his stock was not merely $11,500, the amount of money paid, but also $17,500, the value of his services rendered pursuant to his agreement'."

The petitioner in his brief (p. 47) states that the *Boulton* case is distinguishable. No analysis of the case is there given. Since in the doctor analogy he also, on page 42 of his brief, adopts substantially the facts of the *Boulton* case as the illustration of circumstances under which services may be income, this reference to the *Boulton* case appears to be a part of the matters we have discussed above.

We do not advance the *Boulton* case as being on all fours with the case at bar. The principle enunciated is, however, significant. The court decided that where property is sold for cash and for services rendered under a contract to perform them as a part of the purchase price, the value of the services constituted an integral part of the cost of the property.

Respondent's Interpretation of the Contracts Between the Wyoming Associated and the Refining Company Is the Natural Logical View of Such Contracts, and It Is the Petitioner's Interpretation of Such Contracts Which Is Artificial and at Variance with the Facts.

This case might perhaps be different if the contracts in question had been drawn with a view of tax avoidance or with a view of building up to the highest possible figure the "gross income from the property". As the opinion of the lower court observes (R. 154), this is not true, since the contracts are dated February 1, 1923, and the percentage depletion provision of the statute (Section 204(c)(2) of the Revenue Act of 1926) was not enacted until February 26, 1926, retroactively as to this provision to January 1, 1925. (Revenue Act of 1926, Section 286.) This was the first time the federal revenue acts contained any provision for percentage depletion. Percentage depletion was inserted in the Revenue Act of 1926, applicable to years beginning with 1925, to replace the predecessor discovery value provision of the revenue acts of earlier years. See *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312, 318.

Being unable to attack the contract on this ground, the petitioner urges an interpretation of the contract completely out of line with its obvious purposes and completely at variance with the facts in the record. It is said that Wyoming Associated "chose not to engage in the oil-producing business and preferred the business of allowing the purchaser to engage in the risks of production" (Pet. Br., 46). This statement shows the petitioner's lack of understanding of the dual capacity of the Refining Company under its contracts with Wyoming Associated. It was found by the Board as a fact, upon the basis of substantial evidence (R. 35), that under these contracts the Refining Company was acting as agent for Wyoming Associated down to the point of delivery of the oil. Then, but not until then, it became a vendee. This was after the oil had been completely severed from the realty

and prepared for delivery. This means that the Wyoming Associated did not choose not to engage in the oil-producing business; it engaged in such business through the instrumentality of the Refining Company. The petitioner goes on to argue (Pet. Br., 46) that "different types of business produce different gross incomes from the property", this being "true generally of any taxpayer who owns raw material and chooses to permit a purchaser to prepare it for the market rather than to engage in that business himself"; and urges that the Wyoming Associated, as an owner of oil, did not prepare its product for delivery and sale, but preferred "to charge a lower cash price and to permit the purchaser to undertake the work and expense of preparing the product and making delivery", from which the petitioner concludes that it cannot be said "that the seller's price is the cash price plus the value of the services to him" (Pet. Br., 47).

This is turning the contract completely upside down. The Wyoming Associated did not sell oil under the ground; it sold oil severed from the ground and treated for delivery to the pipe line. True, the extraction of the oil and the treatment thereof above ground was physically accomplished by the Refining Company. But at this stage of the operation the Refining Company did not own any oil; it was performing services, as its contract with Wyoming Associated clearly required it to do, for Wyoming Associated, which did own the oil. Wyoming Associated was not preferring to charge a lower cash price or lessening its work and lowering its price; on the contrary, its price was carefully and deliberately stipulated in the contract as including the services rendered by the Refining Company.

The respondent is not attempting "artificially" to construct its gross income "as if he had engaged in the producer's business" (Pet. Br., 47). There is nothing artificial about the respondent's claim. It is rather the petitioner who is artificially interpreting the provisions of the contract into a type of transaction which never occurred.

THE TOTAL CONTRACT PRICE URGED BY THE RESPONDENT WAS LESS THAN THE FIELD PRICE OF OIL IN THE TAXABLE YEAR, AND IT IS IMMATERIAL IF IN SOME FUTURE DEPRESSION PERIOD PRICE OVERTURNS MAY HAVE TEMPORARILY REVERSED THIS NORMAL RELATIONSHIP.

Petitioner in his brief goes to considerable pains (Pet. Br., 43) to show that conditions might, or possibly in the worst of the depression years did, occur under which the cash part of the price (which the petitioner, begging the question, refers to as the contract price), might amount to more than the prevailing market prices of the oil. Petitioner supports this assertion by a footnote (Pet. Br., 44) showing that in the extraordinary price upset of the depression which was superimposed upon abnormal crude oil supply from the East Texas field, *retail prices* of gasoline fluctuated much less than crude oil prices. Petitioner seems to overlook the fact that in the contracts involved in the instant case, even the cash part of the price is based not upon *retail prices of gasoline,* but upon a composite of the *wholesale* prices received by a specified refiner for *gasoline* and *kerosene* (R. 119).

It is not essential to our case to show that the total price adopted in the contract must be either above or below the open market price of oil at any specific time. Prices under contracts for a period of time frequently get out of step with current open market quotations. That does not prevent contract prices from controlling the dealings and the taxes of the parties. The only use we have made of any argument based on the relationship of total contract price, cash plus services, to open market price is to point out that this total contract price for which we contend was a price reasonably to have been anticipated by the parties, being, on the average over the year 1925, somewhat under the then current market price of like oil (R. 48).

The Twin Bell Decision Lends No Support to Petitioner's Position.

In the argument beginning at page 48 of his brief, petitioner at several points cites the decision of this Court in *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312. We are not sure that we entirely follow this part of petitioner's argument. On page 50 petitioner quotes at some length, from page 321 of the opinion in the *Twin Bell* case, a statement to the general effect that a particular interpretation of a statute will not be adopted merely because any other interpretation may work unjust and unequal results. The argument on respondent's part to which this answer has been addressed, pointing out the greater uniformity of effective tax rate which results from our interpretation of the depletion section of the law, was made originally to the Board, but was not made by the respondent to the court below, and is not now urged in this Court. Even before the Board this was not presented as a basic argument necessary to the establishment of the taxpayer's contention, and was omitted before the Circuit Court of Appeals because the respondent believed that there was some force in the Board Member's reply to this particular argument.

Another part of this argument of the petitioner (Pet. Br., 48) appears to be that even if the production services are "gross income" they are not "gross income *from the property*" (Italics ours). This is only a new form of petitioner's contention, dealt with above, that the services are not gross income. If they constitute gross income at all, it is because they are the selling price of oil stipulated in the sales contract. Since the oil is the product of the property, all elements of its selling price, including an element payable in a form other than cash, is necessarily "gross income from the property".

The quotation from the *Twin Bell* opinion at page 49 of petitioner's brief, taken in its context, deals entirely with the apportionment provision (Sec. 234 (a)(8)). The ex-

cerpt quoted requires apportionment of the depletion allowance as well in a case in which a lessee sells the royalty owner's oil and pays over the royalty in the form of cash, as in a case in which the lessee turns over the royalty oil in kind to the lessor.* From this quotation petitioner draws the quite different conclusion that Congress did not intend "that in addition to the contract price some value to the seller, to be placed on production operations by a purchaser, should be included in the seller's gross income from the property".

In this argument petitioner completely begs the question. The relationship of the parties involved in the *Twin Bell* case was that of lessor and lessee, not seller and purchaser. The respondent is not trying, as in the *Twin Bell* case, to add to its "gross income from the property" someone else's "gross income from the property". The issue in the instant case is: What is the Wyoming Associated's "gross income from the property"? For purposes of analogy to the *Twin Bell* case, it owns the entire property. The respondent's position is simply that part of the gross income from that property is received in the form of services. A decision to the effect that someone else's "gross income from the property" should not be part of the taxpayer's basis for percentage depletion has no bearing upon the determination of what is the taxpayer's "gross income from the property".

In other words, the *Twin Bell* decision has application only where there is divided ownership. The explicit denial by petitioner of any contention on his part that "the Refining Company has a depletable interest in the oil represented by production expenses or any other sum" (Pet. Br., 52), removes our problem from the class of cases to which the *Twin Bell* decision belongs.

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* See *Thomas* v. *Perkins*, 301 U. S. 655, 662.

RESPONDENT AGREES THAT THE REFINING COMPANY HAD NO DEPLETABLE INTEREST IN THE LEASES, BUT RESPONDENT'S INTERPRETATION OF THE CONTRACTS BETWEEN THE WYOMING ASSOCIATED AND THE REFINING COMPANY DOES NOT EXCLUDE THE POSSIBILITY OF A DEPLETABLE INTEREST IN THE REFINING COMPANY.

This leads to the answer to petitioner's point on page 52 of his brief. The argument there is that even though the Refining Company has no depletable interest in the oil, the acceptance of the respondent's contention will, nevertheless, "bar the purchaser from depletable interest."

We agree here with the government's contention that an interest in oil or gas, or some type of ownership, is essential to the right to a depletion deduction (Pet. Br., 52). Petitioner's application of this rule is, however, based upon a complete misconception of the opinion of the court below in the instant case. Since no one but Wyoming Associated owned any interest in the oil and gas, it might well have been argued by respondent that the "entire allowance" of depletion should be given to Wyoming Associated, as the petitioner seems to think has been done. If the market value of the oil is taken as representing the base for computation of "entire allowance" this has not been done, for Wyoming Associated has not been given, for depletion purposes, the market price of oil times barrels produced. The decision of the court below (R. 154) simply permits the inclusion in gross income, for percentage depletion purposes, of the cash contract price of oil plus the value of the services rendered pursuant to the contract "as part of the price for oil purchased" (R. 120). The total gross income computed under the lower court's decision amounts to $7,423,055.74 (the cash contract price of $4,606,535.70 plus a value of services proved by production cost of $2,816,520.04; R. 145), whereas the total gross income calculated with reference to the market price of oil would be $8,411,450.19 (a production in the year

of 4,640,794.50 barrels times the stipulated average field price of $1.808605 per barrel; R. 37). The difference of $988,394.45 is available as a basis for depletion to the purchaser if the purchaser should be held entitled thereto. Therefore the decision of the court below does not deprive the Wyoming Associated's purchaser of any possible depletable interest (see Pet. Br., 52). On the contrary, it leaves, as a basis for such depletable interest, the substantial sum of $988,394.45.*

THE RETURN FILED BY RESPONDENT AND THE BOOKS OF ACCOUNT OF WYOMING ASSOCIATED ARE NEITHER CONCLUSIVE, NOR OF ANY EVIDENTIARY VALUE.

Petitioner argues (Pet. Br., 43) that evidently Wyoming Associated itself did not regard the value of production services as gross income because it did not include this item

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* The Solicitor General is, perhaps, misled by the fact that before the Board of Tax Appeals respondent, at that time petitioner, claimed, alternatively, that the market value of the oil afforded a yardstick to measure the value of the services—in other words, that the total market price would be one way of showing the total price, i. e., cash plus the value of the services. If the taxpayer had stood upon this position before the Circuit Court of Appeals and had been sustained by that court, there might be some ground for the Solicitor General's statement that the Circuit Court of Appeals decision left no possibility of any depletable interest in the purchaser and was, therefore, in conflict with the *Bankline* case and *Signal Gasoline Corp.* v. *Commissioner*, 66 F. (2d) 886 (C. C. A. 9th). But the taxpayer, when it came before the Circuit Court of Appeals, elected to rely upon the cost to the purchaser of performing its services as a sounder measure of value, hence, instead of claiming depletion based on the market price of the oil, the taxpayer asked for depletion only on a lesser sum made up of the contract price of the oil plus the value of the productive services rendered by the purchaser as proved by the stipulated cost thereof. The opinion of the court below permits a computation of depletion only on this basis.

on its books or in its income tax return. The position taken in the return is, of course, not binding on respondent (*Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481). Nor are bookkeeping entries binding (*Helvering* v. *Midland Mutual Insurance Co., supra,* 223; *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 187). But the failure to include the item as gross income on the books or in the income tax return does not even furnish any substantial evidence that Wyoming Associated did not regard the item as gross income. For, had Wyoming Associated gone through the form of including the value of the services in its taxable gross income, it would have been entitled to deduct the same item as an expense incurred on its behalf. The inclusion of the item in gross income, later to be deducted as an expense, would therefore have been an idle gesture on the part of the Wyoming Associated, and its failure to include the item in gross income obviously does not prove that the Wyoming Associated did not regard the item as income.

So far as the value of the services is concerned, the respondent did do the one thing which was of any practical importance. In the return filed it computed percentage depletion on an amount of gross income which, on its then theory, included the value of these services.* To have included the value of the services in the taxable gross income and then to have deducted the same amount as an expense, while it might have satisfied the meticulous requirements of a more pedantic bookkeeping, would have served no useful purpose.

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* This was done by taking 27½% of an amount consisting of the barrels of oil produced from the properties of the company at the market price prevailing in the field in 1925 (R. 37). This was because the respondent at the time of making the return regarded the difference between market price and cash contract price as the fairest method of measuring the value of the services to be included in gross income. This method of taking the value of the services into account for depletion purposes was presented by the respondent before

NO QUESTION OF THE CORRECTNESS OF ANY PARTICULAR MEASURE OF VALUE TO WYOMING ASSOCIATED OF THE PRODUCTION OPERATIONS IS BEFORE THIS COURT.

On page 51 of his brief petitioner introduces another question not covered by his petition for certiorari.* He contends that even if the value of the production operations were property includable in the gross income of Wyoming Associated, the stipulated cost of these services is not a correct measure of their value. No such objection to the measure of value used was made by the Commissioner even before the Board. In fact these costs were all segregated by lease tracts and the results were embodied in a stipulation of facts (R. 59, 145), upon which the case was heard by the Board. The Board Member in his opinion finds with respect to the value thus established by these stipulated costs (R. 40):

> "* * * The value fixed or placed by the parties upon the services rendered would seem to be none other than the actual cost of such services, which is the amount actually expended by the Midwest Refining Co. in producing the oil and not necessarily the difference between the market value and the contract price of the oil. There is no evidence nor reason apparent to us to justify the assumption that such costs as stipulated do not represent the full costs of operation of the properties."

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the Board of Tax Appeals as an alternative to its present computation (R. 38). The opinion of the Board Member expresses a distinct preference for actual cost of these services as a method of valuation—if they are admissible at all—rather than the difference between the market value and the cash part of the price (R. 40). When the case came before the Circuit Court of Appeals the respondent in effect reduced its claim, and took this simpler way to compute the value of such services, namely the actual cost (R. 153).

* For a discussion of the impropriety of this procedure, see pages 2-3 of this brief.

The Commissioner took no cross appeal on this point,* and the court below (R. 154) adopted these stipulated costs as a perfectly satisfactory measure of their value to Wyoming Associated. No specification of error is made by petitioner upon the point (Petition for Certiorari, 7).

The introduction of this question into petitioner's brief in this Court is an attempt to go behind issues of fact upon which the parties were in complete agreement before the Board. The lack of any basis now to reconsider this question of measures of value has been dealt with by this Court in *General Utilities Co.* v. *Helvering*, 296 U. S. 200, 206:

> "The second ground of objection, although sustained by the court, was not presented to or ruled upon by the Board. The petition for review relied wholly upon the first point; and, in the circumstances, we think the court should have considered no other. Always a taxpayer is entitled to know with fair certainty the basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised."

See also *Elmhurst Cemetery Co.* v. *Commissioner*, 300 U. S. 37.

This rule applies with even greater force in such cases as the present in which the whole issue was closed by stipulation in the Board, and was not challenged in any way before the Circuit Court of Appeals. See *Helvering* v. *Gowran*, 58 S. Ct. 154.

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* See *Helvering* v. *Pfeiffer*, 58 S. Ct. 159.

CONCLUSION.

It is submitted that the judgment of the Circuit Court of Appeals is correct and should be affirmed on both of the issues presented.

Respectfully submitted,

HAROLD D. ROBERTS.
Attorney for Respondent,
First National Bank Building,
Denver, Colorado.

RANDOLPH E. PAUL,
VALENTINE B. HAVENS,
70 Pine Street,
New York, New York.
Of Counsel.

APPENDIX.

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 213. For the purposes of this title, except as otherwise provided in section 233—

(a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in

which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period.

* * * * * * * *

SEC. 219. (a) The tax imposed by Parts I and II of this title shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) Except as otherwise provided in subdivisions (g) and (h), the tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that—

(1) There shall be allowed as a deduction (in lieu of the deduction authorized by paragraph (10) of subdivision (a) of section 214) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (10) of subdivision (a) of section 214, or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, mainte-

nance or operation of a public cemetery not operated for profit;

(2) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under paragraph (3) in the same or any succeeding taxable year;

(3) In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary.

(c) For the purpose of the normal tax the estate or trust shall be allowed the same credit as is allowed to a single person under subdivision (c) of section 216, and, if no part of the income of the estate or trust is included in computing the net income of any legatee, heir, or beneficiary, then in addition the same credits as are allowed by subdivisions (a) and (b) of section 216.

(d) If any part of the income of an estate or trust is included in computing the net income of any legatee, heir, or beneficiary, such legatee, heir, or beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as

are, under this section, required to be included in computing his net income. Any remaining portion of such amounts specified in subdivisions (a) and (b) of section 216 shall, for the purpose of the normal tax, be allowed as credits to the estate or trust.

(e) If the taxable year of a beneficiary is different from that of the estate or trust, the amount which he is required, under paragraph (2) of subdivision (b) of this section, to include in computing his net income, shall be based upon the income of the estate or trust for its taxable year ending within his taxable year.

(f) A trust created by an employer as a part of a stock bonus, pension, or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits such part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.

(g) Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor.

(h) Where any part of the income of a trust may, in the discretion of the grantor of the trust, either alone or in conjunction with any person not a beneficiary of the trust, be distributed to the grantor or be held or accumulated for future distribution to him, or where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life

of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in paragraph (10) of subdivision (a) of section 214), such part of the income of the trust shall be included in computing the net income of the grantor.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * * * * *

Admission of Wyoming Into the United States.

The admission of the Territory of Wyoming into the United States is an historical matter of public record. The circumstances of this admission were, briefly, as follows:

Congress organized the Territory of Wyoming in the year 1868. The land comprised in the Territory was, at that time, part of the public domain of the United States. Section 14 of the Act of Congress of July 25, 1868 (15 Stat. at Large 178), creating the Territory of Wyoming, reserved Sections 16 and 36 in each township of the Territory then being formed "for the purpose of being applied to public schools in the state or states hereafter to be erected out of the same."

In the years 1889 and 1890 the people of Wyoming Territory adopted a proposed constitution for the State of Wyoming. This constitution in Article VII, Sections 1, 2, 4, 6 and 7, and Article XVIII, Sections 1 and 2, deals with these land grants. The articles and sections referred to are as follows:

ARTICLE VII.

"Section 1. Public schools. The legislature shall provide for the establishment and maintenance of a complete and uniform system of public instruction, embracing free elementary schools of every needed kind and grade, a university with such technical and professional departments as the public good may require and the means of the state allow, and such other institutions as may be necessary.

"Sec. 2. School revenues. The following are declared to be perpetual funds for school purposes, of which the annual income only can be appropriated, to-wit: Such percentum as has been or may hereafter be granted by congress on the sale of lands in this state; all moneys arising from the sale or lease of sections number sixteen and thirty-six in each township in the state, and the lands selected or that may be selected in lieu thereof; the proceeds of all lands that have been or may hereafter be granted to this state, where by the terms and conditions of the grant, the same are not to be otherwise appropriated; the net proceeds of lands and other property and effects that may come to the state by escheat or forfeiture, or from unclaimed dividends or distributive shares of the estates of deceased persons; all moneys, stocks, bonds, lands and other property now belonging to the common school funds.

* * * * * * * *

"Sec. 4. Restriction in use of revenues. All moneys, stocks, bonds, lands and other property belonging to a county school fund, except such moneys and property as may be provided by law for current use in aid of public schools, shall belong to and be securely invested and sacredly preserved in the several counties as a county public school fund, the income of which shall be appropriated exclusively to the use and support of free public schools in the several counties of the state.

* * * * * * * *

"Sec. 6. Trust Funds. All funds belonging to the state for public school purposes, the interest and income

of which only are to be used, shall be deemed trust funds in the care of the state, which shall keep them for the exclusive benefit of the public schools, and shall make good any losses that may in any manner occur, so that the same shall remain forever inviolate and undiminished. None of such fund shall ever be invested or loaned except on the bonds issued by school districts, or county bonds of the state, or state securities of this state, or of the United States, or on first mortgages on farm lands or such other securities as may be authorized by law.

(Note: The above Sec. 6 is in the form given to it by an amendment adopted in 1916.)

"Sec. 7. Application of school funds. The income arising from the funds mentioned in the preceding section, together with all the rents of the unsold school lands and such other means as the legislature may provide, shall be exclusively applied to the support of free schools in every county in the state."

ARTICLE XVIII.

"Section 1. Land grants accepted—Price limit. The state of Wyoming hereby agrees to accept the grants of lands heretofore made, or that may be hereafter made by the United States to the state, for educational purposes, for public buildings and institutions and for other objects, and donations of money with the conditions and limitations that may be imposed by the act or acts of congress, making such grants or donations. * * *

"Sec. 2. Application of proceeds. The proceeds from the sale and rental of all lands and other property donated, granted or received, or that may hereafter be donated, granted or received, from the United States or any other source, shall be inviolably appropriated and applied to the specific purposes specified in the original grant or gifts."

The United States Congress, with this proposed Wyoming constitution before it, thereupon created the State of Wyoming by an "Act of Admission" referring to the Wyoming

constitution as being "Republican in form and in conformity with the Constitution of the United States". Sections 4, 5 and 12 of the Act of Admission of July 10, 1890 (26 Stat. at Large 222), are as follows:

"Sec. 4. That sections numbered 16 and 36 in every township of said proposed state, and where such sections, or any parts thereof, have been sold or otherwise disposed of by or under the authority of any act of Congress, other lands equivalent thereto, in legal subdivisions of not less than one-quarter section, and as contiguous as may be to the section in lieu of which the same is taken, are hereby granted to said state for the support of common schools, such indemnity lands to be selected within said state in such manner as the legislature may provide, with the approval of the Secretary of the Interior; *Provided,* That section 6 of the act of Congress of August ninth, eighteen hundred and eighty-eight, entitled 'An act to authorize the leasing of the school and university lands in the Territory of Wyoming, and for other purposes,' shall apply to the school and university indemnity lands of the said State of Wyoming so far as applicable.

"Sec. 5. That all lands herein granted for educational purposes shall be disposed of only at public sale, the proceeds to constitute a permanent school fund, the interest of which only shall be expended in the support of said schools. But said lands may, under such regulations as the legislature shall prescribe, be leased for periods of not more than five years, in quantities not exceeding one section to any one person or company; and such land shall not be subject to preemption, homestead entry, or any other entry under the land laws of the United States, whether surveyed or unsurveyed, but shall be reserved for school purposes only.

* * * * * * * *

"Sec. 12. That the State of Wyoming shall not be entitled to any further or other grants of land for any purpose than as expressly provided in this act; and the lands granted by this section shall be held, appropriated, and disposed of exclusively for the purposes herein men-

tioned, in such manner as the legislature of the state may provide." (Act of Congress, July 10, 1890.)

SESSION LAWS OF WYOMING, 1921; "CHAPTER 62":

"Section 1. That Section 712, Wyoming Compiled Statutes of 1920 be amended and re-enacted to read as follows:

"Section 712. The state board of land commissioners and also the state board of school land commissioners shall severally lease all state and school lands belonging to the state in such manner and to such parties as shall inure to the greatest benefit and secure the greatest revenue to the state. Preference shall in all cases be given to applications for leases of either state or school lands to persons who are resident citizens and taxpayers of the state, and applications made by citizens of the state who hold title to lands nearest to any state or school lands applied for and have actual and necessary use for the land applied for and are not applying for the lease for speculation or sale shall be given a preference right over all other applicants to lease the same at such rental as the board shall deem equitable and just; provided, that such preference right shall not be given as against the application of the old lessee who has made valuable improvements upon the lands applied for or on lands in the vicinity thereof, if the board shall find that such preference right will work extreme financial hardship upon such old lessee, or will greatly impair or destroy the value of a ranch or property which has been built up in connection with the lands applied for or of which it forms an important and necessary part, and such preference shall extend to an area of lands equal to twice the area of lands to which such applicant holds title, not, however, to exceed six hundred and forty acres of school or educational institutions lands, or a total of two thousand five hundred and sixty acres of state and school lands. Where two or more applicants claim preference by reason of holding title to lands nearest to lands applied for, the boards shall grant leases upon a basis as nearly equitable as possible. Applications for lease under this section must be filed with the commissioner of public lands

prior to the expiration of any existing lease on the lands applied for and where preference rights under this section are claimed, the basis of such rights must be shown at the time of filing an application for lease, but such showing may be made subsequently and within the time allowed by the commissioner of public lands, provided the application for lease is on file prior to the expiration of the existing lease."

WYOMING REVISED STATUTES, 1931:

"91-804. If mineral lands upon which improvements have been made shall be sold or if such lands shall be leased to other than the owner of the improvements thereon, then such purchaser or such new lessee shall pay to the owner thereof the value of said improvements, at an agreed price with the owner thereof; or if such agreement cannot be reached, then at such price as shall be fixed by appraisement under the authority of the board of land commissioners. The word 'improvements' shall be construed to mean surface improvements, machinery and other equipment used and necessary for the operation of the plant on such land, and work performed in the development of the property for operation and mining when such development work is of practical use in future mineral operations on such land. Wells drilled for oil which do not produce oil in commercial quantities, shafts, tunnels or drifts from which coal or other minerals have been practically exhausted, shall not be considered as improvements. (L. '07, c. 81, §5; C. S. '10, §622; L. '15, c. 80, §2; C. S. '20, §718.)"

REGULATIONS OF BOARD OF LAND COMMISSIONERS ADOPTED JUNE 4, 1919:

"75. No statutory right of renewal of an operator's lease exists, but it is the policy of the Boards to give great consideration to the improvements, expenditures and equity rights of former lessees in granting operator's leases. (Sec. 619, Wyo. Comp. Stat., 1910.)"

SUPREME COURT OF THE UNITED STATES.

No. 600.—October Term, 1937.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Mountain Producers Corporation.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[March 7, 1938.]

Mr. Chief Justice Hughes delivered the opinion of the Court.

Respondent, Mountain Producers Corporation, owned all the capital stock of the Wyoming Associated Oil Corporation and filed a consolidated income tax return for the year 1925. Two distinct questions are involved with respect to the taxable income of the above-mentioned affiliate. These are (1) as to the amount of the gross income of the affiliate for the purpose of the statutory allowance for depletion in the case of oil and gas wells (Revenue Act of 1926, Sec. 204 (c) (2), Sec. 234 (a) (8)); and (2) as to a claim of exemption from taxation of income received by the affiliate under a trust agreement with the owner of an oil and gas lease from the State of Wyoming. The Board of Tax Appeals decided against respondent upon both points (34 B. T. A. 409) and its decision was reversed by the Circuit Court of Appeals. 92 F. (2d) 78. Because of an asserted conflict with a decision of the Circuit Court of Appeals for the Ninth Circuit in the case of *Bankline Oil Company* v. *Commissioner*, 90 F. (2d) 899, (see *Helvering* v. *Bankline Oil Company*, decided this day), we granted certiorari. — U. S. —.

First.—Wyoming Associated, organized in 1919, held certain placer mining claims, leases and operating agreements in the Salt Creek Oil Field in Natrona County, Wyoming. Pursuant to the Oil and Gas Leasing Act of Congress of February 25, 1920, the company exchanged its placer claims for government leases and later certain exchanges were made with the Midwest Oil Company and the Wyoming Oil Fields Company. In 1923, Wyoming Associated made a contract with the Midwest Refining Company by which the former agreed to sell to the latter all the oil produced by it in the

Salt Creek Oil Field and the Refining Company agreed to purchase such oil until January, 1934, upon a sliding scale of prices based upon the average price received by the Refining Company for gasoline and kerosene. Wyoming Associated agreed to give the Refining Company free use of all storage facilities, pipe lines, buildings and equipment, and so much of the oil and gas produced as might be reasonably necessary for production purposes. The Refining Company agreed, as part of the price of the oil thus purchased, to drill, case and maintain all wells, supply water, install and operate pumps, and conduct all development and production operations. The Refining Company agreed to take delivery of the purchased oil at the outlet gates of the measuring tanks located at or near the wells.

Respondent contended that the gross income of Wyoming Associated from its properties during the taxable year, for the purpose of the statutory allowance for depletion, consisted of the total cash payments received by Wyoming Associated, plus the cost of production defrayed by the Refining Company under its contract. The amount of that cost was shown by stipulation. The Board of Tax Appeals limited the gross income of Wyoming Associated to the cash payments received. The Circuit Court of Appeals was of the opinion that the cost of production incurred by the Refining Company should be added in the view that, had Wyoming Associated produced the oil at its own expense, its gross income would have been the amount which it received for the oil sold and it would thus have obtained in cash the proportionate amount which represented the cost of the production.

Laying emphasis upon the provision of the contract that the Refining Company should perform its services as a part of the purchase price of the oil, respondent contends that it is irrelevant that the Refining Company acted for its own benefit; that the production and lifting services were performed prior to delivery of the oil, and that the Refining Company was acting as the agent for Wyoming Associated down to the point of delivery and not until then became a vendee; that thus Wyoming Associated did not sell oil under the ground but oil severed from the ground and treated for delivery; that it was not essential for respondent to show that the total price under the contract must be either above or below the market price at any specified time, and that the price as fixed by

the contract controlled the dealings and the taxes of the parties. Respondent agrees that an interest in oil or gas or some type of ownership is essential to the right of deduction for depletion and assumes that no one but Wyoming Associated owned any interest in the oil and gas in place.

The Government argues that the cash price received for the oil is the seller's entire "gross income from the property" where, as in this instance, the oil is purchased under a contract by which a refiner agrees to defray the expense of the development and production operations and to pay a cash price based on the prices it obtains for the products it sells at its refinery; that the oil production operations were conducted by the Refining Company for its own benefit in order to obtain the oil at a price it deemed to be favorable; that the method of determining the purchase price under the contract was not related to the field market price of oil but was expressly related to a different basis, which might be greater, that is, to a basis consisting of the current prices obtained by the Refining Company for its gasoline and kerosene; that if the development operations had been unsuccessful and no oil had been produced, the services of the Refining Company would still have been paid for by the owner's promise to sell at a fixed price whatever oil might be produced, and that this should be taken to be the meaning of the provision that the Refining Company should perform its services as part of the price for oil purchased; that the owner of oil in place, instead of preparing it for delivery and sale, may prefer to lessen his work, lower his price and thus decrease his gross income from the property and in such case the services which the buyer may perform are not to be regarded as part of that income.

We think that the Government's argument is sound. The evident purpose of the statutory provision controls. It is a unique provision to meet a special case. Analogies sought to be drawn from other applications of the revenue acts may be delusive and lead us far from the intent of Congress in this instance. Congress has recognized that in fairness there should be compensation to the owner for the exhaustion of the mineral deposits in the course of production. *United States* v. *Ludey*, 274 U. S. 295, 302. But to appraise the actual extent of depletion on the particular facts in relation to each taxpayer would give rise to problems of considerable perplexity and would create administrative difficulties which

it was intended to overcome by laying down a simple rule which could be easily applied. To this end, the taxpayer was permitted to deduct a specified percentage of his gross income from the property. See *United States* v. *Dakota-Montana Oil Company*, 288 U. S. 459, 461. Congress was free to give such an arbitrary allowance as the deduction was an act of grace. In answer to the contention that the provision may produce "unjust and unequal results", we have remarked that this is likely to be so "wherever a rule of thumb is applied without a detailed examination of the facts affecting each taxpayer". *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321.

The rule being of this sort for obvious purposes of administrative convenience, we must apply it in the simple manner it contemplates. The 27½ per cent. allowed is a fixed factor, not to be increased or lessened by asserted equities. The term "gross income from the property" means gross income from the oil and gas (*Helvering* v. *Twin Bell Syndicate, supra*) and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. If, in this instance, the development operations had failed to produce oil, it would hardly be said that the expense of drilling, borne under contract by another, constituted "gross income" of the taxpayer within the meaning of the statute. Nor, when oil or gas is produced, does the statute base the percentage on market value. The gross income from time to time may be more or less than market value according to the bearing of particular contracts. We do not think that we are at liberty to construct a theoretical gross income by recourse to the expenses of production operations. The Refining Company for its own purposes undertook the expense of those operations, and Wyoming Associated was content to receive as its own return the cash payments for the oil produced, leaving to the Refining Company the risks of production.

We are of the opinion that the cash payments made by the Refining Company constituted the gross income of Wyoming Associated and was the basis for the computation of the depletion allowance.

Second.—The State of Wyoming, in 1919, made a lease for the term of five years to the Midwest Oil Company covering a section of "school land" (section 36, township 40 north, range 79 west) for the purpose of producing oil and gas, reserving a royalty to

the State. The lease was superseded in 1923 by another lease of like import, running from 1924, the royalty to the State being fixed at 65 per cent. of oil and gas produced. In 1923, the Midwest Oil Company executed a declaration of trust, that it held an undivided 50 per cent. interest in the lease, and in the net proceeds to be realized therefrom, and all renewals thereof, for the benefit of Wyoming Associated. In 1925, the State received the agreed royalty of the oil produced and the proceeds of the sale of the remaining oil were divided between Wyoming Associated and the Midwest Oil Company.

The question is whether Wyoming Associated is subject to a federal income tax with respect to the amount it thus received. Immunity is claimed upon the ground that in this relation Wyoming Associated is a state instrumentality.

By the Enabling Act, the land in question was granted to the State of Wyoming for educational purposes, the proceeds to constitute a permanent school fund. Authority was given to lease such land for not more than five years. Act of July 10, 1890, c. 664, secs. 4, 5, 26 Stat. 222, 223. Apart from the fact that the claim is made by Wyoming Associated by virtue of the declaration of trust, and not by the lessee, the case would fall directly within the decision in *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, relating to a federal tax upon net income derived by a lessee under a lease of "school lands" by the State of Oklahoma. In *Burnet* v. *Jergins Trust*, 288 U. S. 508, we limited the application of the *Coronado* case, saying that the doctrine invoked was to be applied strictly. But a distinction solely upon the ground that the income in the instant case was received under a declaration of trust by the lessee, and not by the lessee itself, does not appear to be substantial and we are of the opinion that the *Coronado* case and the decision upon which it rested should be reconsidered in the light of our other decisions as to the taxing power.

The *Coronado* case was decided as a corollary to the case of *Gillespie* v. *Oklahoma*, 257 U. S. 501. The court there denied to Oklahoma the right to enforce its tax upon net income derived by a lessee from sales of his share of oil and gas received under leases of restricted Indian lands. See *Choctaw, Oklahoma & Gulf R. R. Co.* v. *Harrison*, 235 U. S. 292; *Indian Territory Illuminating Oil Co.* v. *Oklahoma*, 240 U. S. 522. As Oklahoma was thus barred

from enforcing its tax upon the income of a federal lessee of Indian lands, the Court in the *Coronado* case held that a similar principle should be applied to the enforcement of a federal tax upon the income of the State's lessee of school lands. In such a case, as the State was executing a trust imposed by Congress as a condition of the State's entering the Union, the cases in which the State had engaged in business enterprises, apart from what should be deemed to be its essential governmental functions, were thought to be inapplicable. 285 U. S. p. 400.

The ground of the decision in the *Gillespie* case, as stated by Mr. Justice Holmes in speaking for the Court, was that "a tax upon the leases" was "a tax upon the power to make them, and could be used to destroy the power to make them" (240 U. S. p. 530) and that a tax "upon the profits of the leases" was "a direct hamper upon the effort of the United States to make the best terms that it can for its wards". In the light of the expanding needs of State and Nation, the inquiry has been pressed whether this conclusion has adequate basis; whether in a case where the tax is not laid upon the leases as such, or upon the government's property or interest, but is imposed upon the gains of the lessee, like that laid upon others engaged in similar business enterprises, there is in truth such a direct and substantial interference with the performance of the government's obligation as to require immunity for the lessee's income. We have held that the ruling in the *Gillespie* case should be limited strictly to cases closely analogous (*Burnet* v. *Coronado Oil & Gas Co., supra*), and the distinctions thus maintained have attenuated its teaching and raised grave doubt as to whether it should longer be supported.

In numerous decisions we have had occasion to declare the competing principle, buttressed by the most cogent considerations, that the power to tax should not be crippled "by extending the constitutional exemption from taxation to those subjects which fall within the general application of non-discriminatory laws, and where no direct burden is laid upon the governmental instrumentality and there is only remote, if any, influence upon the exercise of the functions of government". *Willcuts* v. *Bunn*, 282 U. S. 216, 225, and illustrations there cited. Thus we have held that the compensation paid by a State or a municipality to a consulting engineer for work on public projects may be subjected to a federal

income tax (*Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514, 524) and that the income of independent contractors engaged in carrying on government enterprises may be taxed. *James* v. *Dravo Contracting Company,* decided December 6, 1937. We have always recognized that no constitutional implications prohibit a non-discriminatory tax upon the property of an agent of government merely because it is the property of such an agent and used in the conduct of the agent's operations and necessary for the agency. *McCulloch* v. *Maryland,* 4 Wheat. 316, 436; *Railroad Company* v. *Peniston,* 18 Wall. 5, 33; *Alward* v. *Johnson,* 282 U. S. 509, 514. The Congress may tax state banks upon the average amount of their deposits, although deposits of state funds by state officers are included. *Manhattan Company* v. *Blake,* 148 U. S. 412. Both the Congress and the States have the power to tax transfers or successions in case of death, and this power extends to the taxation by a State of bequests to the United States and to the taxation by the Congress of bequests to States or their municipalities. *United States* v. *Perkins,* 163 U. S. 625; *Snyder* v. *Bettman,* 190 U. S. 249, 253, 254. While a tax on the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government (*Weston* v. *Charleston,* 2 Pet. 449, 468, 469; *Pollock* v. *Farmers Loan & Trust Co.,* 157 U. S. 429, 586), the sale of the bonds by their owners after they have been issued by the State or municipality is regarded as a transaction distinct from the contracts made by the government in the bonds themselves, and the profits of such sales are subject to the federal income tax. *Willcuts* v. *Bunn, supra,* p. 227. See, also, *Burnet* v. *Jergins Trust, supra; Helvering* v. *Therrell,* decided February 28, 1937; and *Helvering* v. *Bankline Oil Company,* decided this day.

In *Group No. 1 Oil Corporation* v. *Bass,* 283 U. S. 279, profits derived by a lessee from the sale of oil and gas produced under a lease from the State of Texas were held not to be immune from federal taxation. This decision was distinguished in the *Coronado* case upon the narrow ground that under the law of Texas the leases effected a present sale to the lessee of the oil and gas in place. In *Indian Territory Oil Company* v. *Board,* 288 U. S. 325, the Court sustained a non-discriminatory *ad valorem* tax imposed by the State of Oklahoma on oil extracted from restricted Indian lands under

leases approved by the Secretary of the Interior, where the oil had been removed from the lands and stored in the owner's tanks and the Indians had no further interest in it.

These decisions in a variety of applications enforce what we deem to be the controlling view—that immunity from non-discriminatory taxation sought by a private person for his property or gains because he is engaged in operations under a government contract or lease cannot be supported by merely theoretical conceptions of interference with the functions of government. Regard must be had to substance and direct effects. And where it merely appears that one operating under a government contract or lease is subjected to a tax with respect to his profits on the same basis as others who are engaged in similar businesses, there is no sufficient ground for holding that the effect upon the Government is other than indirect and remote. We are convinced that the rulings in *Gillespie* v. *Oklahoma, supra,* and *Burnet* v. *Coronado Oil & Gas Company, supra,* are out of harmony with correct principle and accordingly they should be, and they now are, overruled.

In the instant case, we find no ground for concluding that the tax upon the profits of Wyoming Associated derived under its lease from the State constituted any direct and substantial interference with the execution of the trust which the State has assumed, and the decision of the Circuit Court of Appeals to the contrary must be reversed.

Reversed.

Mr. Justice CARDOZO and Mr. Justice REED took no part in the consideration and decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.

SUPREME COURT OF THE UNITED STATES.

No. 600.—October Term, 1937.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Mountain Producers Corporation. | On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[March 7, 1938.]

Mr. Justice Butler, dissenting.

At least since *M'Culloch* v. *Maryland* (1819), 4 Wheat. 316, the ual form of government resulting from the adoption of the Con- titution has been deemed necessarily to imply that no State may ax the operations of the Federal government in the exertion of owers that the people delegated to it and that, for the same reason, he Federal government may not tax the operations of any State n the exertion of any of its essential functions of government. As o that principle, the urgency of governmental demand for money oes not justify yielding here. No one can foresee the extent to hich the decision just announced surrenders it. The transactions f a State for the purpose of raising money to provide for schools re admittedly within the principle as heretofore it has been under- ood and applied. Now this Court makes it lawful for the United tates to lay tribute upon them.

A few citations will be sufficient to suggest the character of the ange so wrought.

M'Culloch v. *Maryland* held that impliedly the Federal Consti- tion forbade imposition by Maryland of any tax upon the opera- ons of the Bank of the United States within that State. There hief Justice Marshall, speaking for a unanimous Court, demon- rates (p. 426): "1st. that a power to create implies a power to reserve. 2nd. that a power to destroy, if wielded by a different nd, is hostile to, and incompatible with these powers to create d to preserve. 3d. that where this repugnancy exists, that au- ority which is supreme must control, not yield to that over which is supreme."

Farmers Bank v. *Minnesota* (1914), 232 U. S. 516, held that a State cannot tax bonds issued by a territory of the United States; that a tax upon the bonds is a tax on the government issuing them; that such a tax, if allowed at all, may be carried to an extent that will entirely arrest governmental operations. The Court rested that decision upon *M'Culloch* v. *Maryland*, saying (p. 521): "The principle has never since been departed from, and has often been reasserted and applied."[1]

Choctaw & Gulf R. R. v. *Harrison* (1914), 235 U. S. 292, held that, where by agreement with an Indian tribe the United States assumed a duty in regard to operation of coal mines, the lessees of the mines were instrumentalities of the government and could not be subjected to a state occupation or privilege tax.[2]

Indian Oil Co. v. *Oklahoma* (1916), 240 U. S. 522, held that oil leases in Oklahoma made by the Osage tribe were under the protection of the Federal government; that the corporation owning the leases was a federal instrumentality and that therefore the State could not tax its interest in the leases, either directly or by taxing the capital stock of the corporation owning them.[3]

Gillespie v. *Oklahoma* (1922), 257 U. S. 501, held that net income derived from leases like those considered in *Choctaw & Gulf R. R.* v. *Harrison, supra,* and *Indian Oil Co.* v. *Oklahoma, supra,* could not be taxed by the State; for the lessee was an instrumentality used by the United States in fulfilling its duties to the Indians.[4] The Court said (p. 506): "The same considerations that invalidate a

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[1] Citing Osborn *v.* U. S. Bank, 9 Wheat. 738, 859; Home Savings Bank *v.* Des Moines, 205 U. S. 503, 513; Grether *v.* Wright, 75 Fed. 742, 753.

[2] Citing M'Culloch *v.* Maryland, 4 Wheat. 316; Farmers Bank *v.* Minnesota, 232 U. S. 516.

[3] Citing Choctaw & Gulf R. R. *v.* Harrison, 235 U. S. 292.

[4] Citing Choctaw & Gulf R. R. *v.* Harrison, 235 U. S. 292; Indian Oil Co. *v.* Oklahoma, 240 U. S. 522; Howard *v.* Gipsy Oil Co., 247 U. S. 503; Large Oil Co. *v.* Howard, 248 U. S. 549.

As to taxability of gains from interstate commerce, see United States Glue Co. *v.* Oak Creek, 247 U. S. 321; Shaffer *v.* Carter, 252 U. S. 37, 57.

In Burnet *v.* Coronado Oil & Gas Co., 285 U. S. 393, 399, 400, it is stated that Gillespie *v.* Oklahoma has often been referred to as the expression of an accepted principle, citing Metcalf & Eddy *v.* Mitchell, 269 U. S. 514, 522; Jaybird Mining Co. *v.* Weir, 271 U. S. 609, 613; Northwestern Insurance Co. *v.* Wisconsin, 275 U. S. 136, 140; Heiner *v.* Colonial Trust Co., 275 U. S. 232, 234; Shaw *v.* Oil Corp., 276 U. S. 575, 579; Panhandle Oil Co. *v.* Knox, 277 U. S. 218, 221, 222; Carpenter *v.* Shaw, 280 U. S. 363, 366; Willcuts *v.* Bunn, 282 U. S. 216, 229; Group No. 1 Oil Corp. *v.* Bass, 283 U. S. 279, 282, 283; Indian Motocycle Co. *v.* United States, 283 U. S. 570, 576; Choteau *v.* Burnet, 283 U. S. 691, 696.

tax upon the leases invalidate a tax upon the profits of the leases, and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards."

Jaybird Mining Co. v. *Weir* (1926), 271 U. S. 609, held that where mining land was leased by incompetent Indian owners with the approval of the Secretary of the Interior, in consideration of royalty in kind, a state *ad valorem* tax assessed to lessee on ores in bins on the land, before sale or segregation, was void as an attempt to tax an agency of the Federal Government.[5]

In *Burnet* v. *Coronado Oil & Gas Co.* (1932), 285 U. S. 393, it appeared that lands granted by the United States to Oklahoma for the support of common schools were leased by the State to a private company for extraction of oil and gas, the State reserving a part of the gross production, the proceeds of which were paid into the school fund. We held that the lease was an instrumentality of the State in the exercise of a strictly governmental function, and that application of the federal income tax to the income derived from the lease by the lessee was therefore unconstitutional.[6]

To reach in this case the conclusion that respondent's affiliate is subject to federal income tax on the proceeds of its share of the oil received under the lease of state school lands, this Court expressly overrules *Gillespie* v. *Oklahoma, supra,* and *Burnet* v. *Coronado Oil & Gas Co., supra;* and with them necessarily goes a long line of decisions of this and other courts. The opinion brings forward no real reason for so sweeping a change of construction of the Constitution. It is to the plain disadvantage of Indian wards of the national government and school children of the several States; it threatens many business arrangements that have been made for their benefit.

I dissent.

Mr. Justice McREYNOLDS concurs in this opinion.

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[5] Citing Farmers Bank *v.* Minnesota, 232 U. S. 516; Choctaw & Gulf R. R. *v.* Harrison, 235 U. S. 292; Indian Oil Co. *v.* Oklahoma, 240 U. S. 522; Gillespie *v.* Oklahoma, 257 U. S. 501; Howard *v.* Gipsy Oil Co., 247 U. S. 503; Large Oil Co. *v.* Howard, 248 U. S. 549.

[6] Following Gillespie *v.* Oklahoma, 257 U. S. 501. Citing Texas *v.* White, 7 Wall. 700, 725; Collector *v.* Day, 11 Wall. 113; Pollock *v.* Farmers Loan & Trust Co., 157 U. S. 429, 584; Farmers Bank *v.* Minnesota, 232 U. S. 516, 527.